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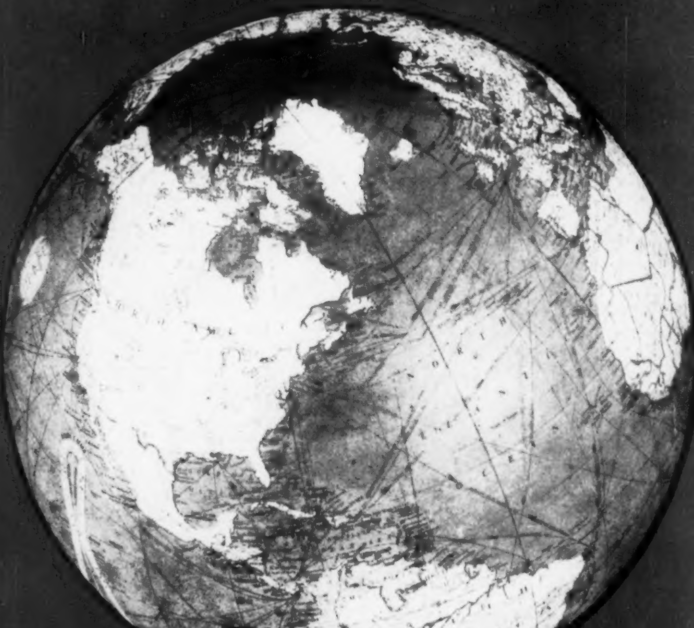

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The Tax Picture of Revolving Credit Accounts

By Henry B. Jordan

In the past decade there has been a growing trend by retail establishments such as department stores, clothing chains, and specialty shops to use the "revolving credit" type of account in connection with the sale of merchandise. Under this type of credit arrangement the store and the customer have a written agreement which permits the customer to purchase merchandise on credit up to a maximum dollar limitation, and to pay for the merchandise in monthly installments. The agreement provides that all revolving credit purchases of the customer throughout the store will be charged to his revolving credit account and that he will pay for those purchases in monthly installments of a fixed minimum amount or based upon a fraction (usually 1/10) of the unpaid balance of the account. A customer who reaches his credit limit in the account may later charge additional purchases to that account only to the extent that his monthly payments have reduced his account balance below the maximum credit figure. A monthly carrying charge, representing interest and service costs, is made on the basis of the unpaid balance in the account. The usual carrying charge is from 1 to 1½ per cent of the unpaid balance.

Revolving credit plans are known by many different names in the merchandising field but the underlying principle of the plans is generally the same as described above. Some of the common names for this type of credit arrangement are "budget accounts," "cycle budget accounts," "continuous budget accounts," and, of course, the familiar "revolving credit accounts."

The revolving credit type of installment account is attractive to retailers and customers alike because it permits the sale of merchandise on the installment plan to customers who would be unable to pay their accounts in full under the standard 30-day

charge account arrangement, and permits the sale of relatively low-priced items under the installment plan. Traditionally, the standard installment contract has been used only in connection with the sale of higher priced items such as major household appliances, radio and television sets, and other durable goods. Not the least of the attractive features to the retailer is the additional income produced by the 1 or 1½ per cent service charge.

A customer may have a revolving credit account in addition to an account or accounts under separate installment contracts for the purchase of higher priced items. It is not usual, however, for a customer to have a 30-day charge account and revolving credit account with the same store.

Tax Problems Involved

A question which remains unanswered is whether revolving credit plans qualify as installment plans under section 453(a) of the Internal Revenue Code. If they do, the retailer has the advantage of recognizing taxable income from his revolving credit sales as amounts are collected rather than at the time of sale under the accrual method of accounting. The regulations under section 453 contain detailed rules relating to the installment method of accounting but they do not deal specifically with revolving credit plans. Instead, when the final regulations under that section were issued in September 1958, the introductory paragraph included the following statement: "Consideration is being given to the issuance of separate rules dealing with the matter of whether

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income from so-called 'revolving credit sales' may be reported under the installment method of accounting provided for under section 453."

The pioneer case involving the revolving credit issue is *Consolidated Dry Goods Co.*, 60-1 U.S.T.C. 9272 and 5 A.F.T.R. 2d 920. In that case the Massachusetts District Court held on February 5, 1960, that the taxpayer's "Cycle Budget Account Plan" qualifies as an installment plan under section 453(a). That case involves a corporation operating department stores and using the accrual method of accounting. Sales of merchandise are made for cash and under different credit arrangements. The corporation uses the conventional charge account arrangement (30-day accounts) under which merchandise purchased during one billing period is to be paid for in full before the next billing date. Under another arrangement requiring a separate contract for each sale, payments are to be made in regular fixed installments until the debt is completely liquidated, with the corporation retaining title and the right of possession until that time. This is the standard installment contract type of account. The corporation also uses its Cycle Budget Account Plan, under which the store and the customer by agreement establish a credit limitation for the customer, usually six times the customer's monthly payment. The customer agrees to make a fixed monthly payment as long as there is an unpaid balance in the account, plus a service charge of 1 per cent of the unpaid balance. It is this latter plan which the court recognized as an installment plan for Federal income tax purposes, and described as a typical example of what is known in the merchandising field as a revolving credit plan. Since the case involved years under both the 1939 Code and the 1954 Code, the principle of that decision is pertinent for current years as well as for past years still open.

The favorable *Consolidated* decision has provided hope for the many retail establishments which have long wanted to apply the installment method to revolving credit plan accounts. Although the Treasury has decided not to appeal the *Consolidated* decision, it has announced in Technical Information Release 247, August 23, 1960, and in Revenue Ruling 60-293, I.R.B. 1960-37, that it will not follow it. That release and ruling also announced that a study is now under way as to whether workable standards can be formulated for determining what part of revolving credit sales qualify as installment sales under section 453 of the Code.

It is believed that the Treasury has delayed taking a position on the revolving credit issue because of the difficulty of solving the

many problems which are entailed in recognition of the system under section 453. Under the revolving credit plan, the buyer's regular monthly payment is not specifically attributed to the purchase price of any separate item but is applied to his revolving credit account to reduce the balance in that account, which may consist of the purchase price of different items purchased in different departments with varying gross profit percentages. Under these circumstances, it would appear that under O.D. 25, 1 C.B. 75, for tax purposes the store would have to make a detailed segregation to determine departmental gross profit percentages for revolving credit sales only, excluding sales for cash and under other credit arrangements, and to analyze the customer's accounts, in the case of multiple credit arrangements, to allocate the payment to the proper account or accounts. It would also seem necessary to devise a system to allocate the monthly payment among the departments where purchases had been made. It is interesting to note that in *Blum's, Inc.*, 7 B.T.A. 737 (nonacq.), the court allowed the use of a composite gross profit percentage because it considered that there was not a sufficient distortion of income. The proposed regulations under section 453 also provided for the use of storewide gross profit percentages, but that provision was not in the final regulations. If the final rule is that departmental gross profit percentages must be used, it is apparent that the cost of making the necessary analyses might in many cases be greater than any tax benefit to be derived from the use of the installment method in connection with revolving credit plans.

It is believed that the Treasury will be successful in its efforts to develop rules which will be reasonable without creating any undue hardships or benefits. Thus, it is predicted that acceptance of revolving credit sales as installment sales under section 453 will be the eventual answer, although that may be many months away. Meanwhile, many companies have treated revolving credit sales as installment sales for tax purposes and it is believed that the Treasury will hold up action on the returns of such companies rather than to continue to litigate this point.

Avoidance of Double Taxation

Adoption of the installment method of accounting under section 453(a) by retailers who are planning to use the revolving credit plan, and by retailers who are presently using the revolving credit plan, may involve possible double taxation in part of amounts collected on installment sales which have previously been

included in income in the year of sale. Section 453(c) provides relief from double taxation of installment sales but in some cases the relief is only partial.

Practitioners have believed for some time that double taxation upon adoption of the installment method could be avoided completely by the sale of installment accounts at the end of the year preceding the year of adoption of the installment method of accounting for tax purposes. In Revenue Ruling 54-43, the Treasury recognized as a bona fide sale for tax purposes the monthly sale of installment accounts by a merchant to a bank at a discount, and held that the losses from the sales are deductible in full. In the case of *City Stores Co.*, 57-2 U.S.T.C. 9960 and 1 A.F.T.R. 2d 411, the Treasury tried to treat the transactions as loans rather than sales, but the District Court recognized the transactions as bona fide sales for tax purposes under the 1939 Code. That case involved the sale of installment accounts to banks at a discount at the end of the year prior to adoption of the installment method of accounting. Later, in Revenue Ruling 59-343, the Treasury announced that it would follow the decision in the *City Stores* case. Thus, where a taxpayer makes a bona fide sale of customers' obligations to a bank at the end of a particular taxable year and then elects for the following taxable year to adopt the installment method of reporting income, the taxpayer need not include, in computing taxable income for the later years, amounts collected which are attributable to installment obligations previously sold.

The terms of any contract covering the sale of installment accounts are subject, of course, to negotiation between the store and the purchaser of the accounts, usually a bank. However, there are key features of the contract which should be so handled that the Treasury will recognize the transaction as a sale and not a loan. It is important to make certain that the contract speaks of "sale" and "purchase." Any language suggesting that the transaction is a loan should be omitted. Also, as a part of the contract, the store should assign all right, title, and interest in the accounts and the merchandise sold thereunder.

In the usual sale transaction the consideration is the face value of the accounts less a discount based on the prime interest rate in existence at the contract date and the length of time expected to pass before all the accounts are collected in full. The bank remits in a lump sum after withholding a "reserve for losses" or "deferred payment," which is turned over to the store after all accounts have been collected or have been repurchased by the store. The

purpose of the reserve is to insure that all the accounts sold are binding and undisputed obligations of the debtors, as well as to provide for losses on collections. The Treasury is known to have issued favorable rulings involving a reserve as high as 15 per cent but, of course, the lower the reserve the better chance there is for Treasury approval. The Treasury frowns on excessive reserves, so the contract usually provides for a decreasing reserve based on a percentage of the uncollected accounts, or requires that any reserve in excess of the uncollected accounts be remitted to the store when such excess occurs. For obvious reasons the first method is preferred by stores while the banks favor the latter.

The store generally continues to maintain and collect the sold accounts at its own expense as agent for the bank, but the Service requires that the accounts be segregated or otherwise identified as belonging to the bank by imprinting or stamping a legend such as "Sold to the First National Bank as of November 30, 1960" on the account cards.

As a protective measure banks often require the store to repurchase any defaulted accounts at face value. The Treasury holds that the basis to the store of such repurchased accounts is their face value, and that subsequent collections on the account are not taxable income to the store unless more than the face amount is collected.

The 1 or 1½ per cent service charge on the accounts is kept by the store as compensation for its cost of maintaining and collecting the accounts for the bank. The Treasury informally recognizes this procedure but probably would not rule on it officially now because it involves a feature which is peculiar to revolving credit accounts.

Amounts collected by the store for the bank should be turned over to the bank frequently. Many contracts require remittance monthly or oftener according to a schedule of anticipated collections, and provide for an adjustment of the discount rate if the rate of collections is more or less than anticipated.

While the usual contract of sale of installment accounts is made with a bank, there is no reason why the Treasury should not recognize the validity of a bona fide sale to any other person. If the parties are related, of course, the provisions of section 267 of the Code might deny the loss (discount) on the transaction to the selling store; and if a related party purchases the accounts at face value without a discount or with only a nominal discount,

the Treasury might refuse to rule favorably on the theory that the transaction is not at arm's length.

Conclusion

It is clear from these recent rulings that double taxation of installment sales can be avoided completely by the sale of the installment accounts before the year of adoption of the installment method. The Treasury has in recent months issued favorable rulings to taxpayers whose sale of accounts was undertaken as the first step in the adoption of the installment method of accounting for revolving credit sales. Although the Treasury has not yet recognized revolving credit plans as installment plans for tax purposes, and although its ruling letters on sales of accounts contain the following caveat—"This ruling should not be construed as a ruling on the question of whether revolving credit accounts (or accounts having similar features which may be called by another name) are installment accounts within the meaning of section 453 of the 1954 Code"—taxpayers are going ahead with their plans to use the installment method of reporting revolving credit sales for tax purposes. For the present this procedure seems justified. If the Treasury does not soon recognize the principle of the *Consolidated* decision there is certain to be further litigation on the revolving credit issue by other taxpayers. Eventually this issue may reach the Supreme Court but it is predicted here that the Treasury will yield on this question as soon as it can develop workable rules for treating revolving credit accounts under section 453 of the Code.

Over-all Checks in Auditing

By Leopold A. Bernstein

By subjecting financial statements to some of the same tests used by the reader to gain an understanding of their significance, the auditor will be able to better serve those who rely on the presentation, usefulness, and full disclosure of his reports.

Among the many ways of classifying audit procedures, one is to divide them into two groups—over-all tests and test checks. Over-all checks involve a broad view of the data under audit and the interrelationship and reasonableness of that data, in light of the condition of the company and the economics of the industry in which it operates. The techniques used are over-all tests of financial data, independent calculation of amounts in financial statements, and review of internal control and internal check. Test checks focus on the individual components of the accounts. The methods used here consist of vouching and testing, mathematical checks, and analyses of individual accounts. Although both approaches are essential, I believe that over-all checks will assume an ever increasing importance in auditing.

The field of over-all checks is so broad in scope that an all-embracing definition is difficult. Generally, by over-all checks we mean the critical examination and the interpretation and explanation of the relationship that exists between sets of business and financial data at a certain point in time, or their comparison over a number of periods. They include the use of ratios, indices, percentage relationships, and comparisons in such a way as to highlight the abnormal, the changing, or the unexpected. Their value is obvious since a figure standing by itself has no significance and gains meaning only when related to other sets of figures or data. Explanations of changes in relationships contribute to the over-all understanding of the accounts audited and may point to further areas of inquiry.

At least two contemporary trends point towards the ever increasing importance of over-all checks. The first of these is the advent of electronic data processing which has changed and will continue to change auditing techniques even more drastically. Even though the broad aims of auditing will remain the same, procedures will have to be revised constantly to recognize the

changes in the technology of accumulating data. When electronic data processing systems are installed, the audit trail no longer follows the familiar route of handwritten or mechanically printed visible records, but instead is represented frequently by symbols of computer language on tape, paper, or cards, which media often have only a short lifespan, representing as they do only intermediate records in the numerous processes of the system.

The Influence of Computers

In contrast to the detailed and tedious checking designed to test the mathematical and logical accurateness of the many individuals performing routine accounting functions, the mathematical reliability of a computer can be tested periodically by the auditor by such means as test problems and maintenance checks. Provided there is adequate control over its maintenance and direction, the auditor may be reasonably sure that the computer in its particular task will not have the fallibility of humans. Just as the computer upgraded the ways of data processing, so it brought with it an upgrading of the work of the auditor, who, freed of much of the mechanical checking and arithmetical verification, can devote an

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increasing amount of time to analytical and evaluative processes. Consequently, the concentration on over-all checking for reasonableness, the investigation of the different and the unexpected variance—all within the framework of a sound knowledge of the client's business and his industry—will assume ever greater importance in the work of the auditor.

Secondly, the increasingly complex business problems of an advanced society such as ours and the equally complex and refined tools (variable budgets, income analyses, cost systems, and return on investment computations, to mention a few) brought to bear upon their solution have a profound influence on the auditor's work. As an outside professional, employed by the company on a recurring basis, the auditor is expected to be familiar with these techniques for two reasons:

a. Tools of scientific management as they are applied to business problems influence accounting policies significantly, and thus a mastery of these tools is essential to the auditor in his work.

b. Far from being merely confronted with these established tools, the auditor, because of his varied experience and specialized training, will be expected to contribute to their installation. To the auditor, the application of over-all checks is akin to the use of scientific controls by management. The conclusions reached through the application of over-all checks point to the areas where such controls may be applied most rewardingly.

In planning the use of over-all tests, a thorough familiarity with the company's business, the industry it is in, and the business and accounting practices peculiar to that industry are of primary importance. A thorough understanding of the systems and procedures used by the company to implement management's policy and philosophy is also essential. These will include the accounting function as well as other major functions such as sales, production, finance, and personnel. The auditor should also familiarize himself with the sources of comparative information on the client's industry so that yardsticks may be available when needed. As with many other tools at the auditor's disposal, the application of over-all tests will vary greatly with the type of engagement, quality of internal control, and practices of the industry of which the client is a part. This article will not present an exhaustive list of such tests but rather mention some of the more important.

Current Assets

The first over-all check to suggest itself is the use of the current ratio. Aside from its value to management and external analysts

of the company's credit rating or investment merit, its significance lies in its comparison to ratios of prior periods. The auditor will want an explanation of any significant variations from previous relationships since such deviations from normal usually form the basis for fruitful inquiry. One direction such inquiry may take would be the scrutiny of the consistency of classifications of current assets and current liabilities. Another may involve the use of a statement of source and application of funds which would explain changes in working capital and to which we shall refer later.

The relationship of cash to sales is a meaningful one since usually a certain amount of cash is needed to support a certain level of sales. An amount of cash exceeding what might be considered normal for ordinary operations may suggest absence of investment opportunities, segregation of funds for acquisitions or expansion, or the accumulation of funds to meet a contingency of which the auditor may not be aware. An additional measure is the liquidity ratio. It is expressed as the percentage of cash or equivalent to total current liabilities, and its comparison over the years may prove valuable.

Accounts receivable lend themselves very well to over-all testing. Aging is a familiar tool frequently employed by the auditor. The comparison over the years of the percentage composition of the different age groups of the account will shed light on the quality of the whole and the reasonableness of the bad debt reserve. Thus, if the over ninety days old accounts are 25 per cent of the total as compared to 10 per cent last period, the over-all collectibility of the accounts may have deteriorated. However, further inquiry may disclose, for example, that the increase in these accounts is brought about by changes in credit policies or in merchandising policies.

Inventories are frequently assets of importance and materiality and may be subjected to various tests and checks. Over-all checks which supplement test checks of component items are among the best tools available to the auditor.

Given a management policy on inventory levels, the relationship of inventory to sales is an important one, variances in which justify close examination. Growth in inventory not attended by commensurate growth in sales may indicate management's failure to control inventory levels, but may also arise from an erroneous computation of the inventory. Larger inventories may be caused by a change in the mix of merchandise sold or by higher minimum

stock levels. Special situations such as accumulation in anticipation of a strike must also be considered.

Inventory turnover is a good measure of inventory heaviness. Heavy inventories may indicate obsolescence or style changes, and a comparison of inventory composition at the year end may pinpoint obsolete stock.

Fixed Assets

The ratio of fixed assets to sales volume may indicate the investment in plant necessary to maintain a given volume of business. In a period of gradual inflation this relationship cannot always remain constant, but an analysis of sharp changes may reveal conditions of excess capacity or relatively large retirements. Unusually large gains or losses on fixed assets may indicate the need for a revision of depreciation rates.

A large increase in fixed assets that is not, in due course, accompanied by a commensurate increase in sales may be indicative of a miscalculation on management's part of its ability to increase sales with productive capacity. This situation may explain changes in profit margins, profitability, or higher overhead rates per unit.

Current Liabilities

A good measure of accounts payable that provides comparability from year to year is the computation of days of purchases outstanding. This indicates how promptly the company pays its bills, and any sharp changes may provide clues to unrecorded liabilities or explanations of changes in cash discounts earned.

The ratio of accruals of individual expense accounts to total expenses may under certain conditions provide checks on the adequacy of the accrual or the propriety of the cutoff procedure. The longer the time series of ratios developed over the years, the more reliable this type of check becomes. Year to year comparisons of accruals also provide valuable over-all checks on their adequacy.

Long-term Liabilities and Capital Accounts

The number of over-all tests that can be applied to long-term debt is limited. However, the comparison of the relationships between debt and equity capital, and debt and interest cost from year to year may be instructive. The former shows the composition of the company's capital sources and has some bearing on

over-all results since interest is an expense while dividends are an appropriation of net income. The latter presents a history of capital costs to the company and is a rough check on both interest expense and debt outstanding. As with most over-all tests, the actual inquiries and investigations leading to an explanation of these changes will add considerably to the knowledge and understanding of the business.

Returns on equity vary among industries and among members of one industry. Return on equity is a significant ratio and year to year fluctuations should be analyzed and explained. Great care must, however, be exercised to determine the accuracy and comparability of figures that are externally generated.

Sales

The audit of sales has frequently posed perplexing problems. The difficulty here, of course, is that in relation to other accounts the volume of detail is apt to be impressive. Consequently, in assessing the reasonableness of sales, over-all checks find one of their most practical applications.

The best way to build up comparison ratios of sales is to analyze them over the years in sufficient detail to be meaningful. The emergence of well defined patterns and relationships leads not only to a better analysis but also to a more effective disclosure of areas in which variances arise.

Analyses of sales or their correlation to other accounts, such as material consumption, freight-out, and gross profit, will vary greatly from one examination to another. Generally speaking, sales may be compared by:

a. departments, categories, groups
b. physical volume (i.e., total sales divided by average sales price)
c. major consumers or customers
d. territory or geographical areas
e. volume by selling season or period.

Physical volume of sales and production is a more reliable measure of activity than dollar volume since the former eliminates the element of price change. However, if costs tend to change proportionately with sales prices, then dollar sales may be a good measure of activity.

Significant conclusions may also be reached by relating company sales to share of the industry and by comparing percentage changes of industry sales during a period to those of the company.

Among the most popular over-all sales tests is that using the traditional gross profit ratio. We shall refer to this test later.

In the area of service income, the various yardsticks are peculiar to the industry in which they are applied; revenue per passenger mile and income per guest are examples.

Among other income items, income from the sale of scrap can usually be checked against an experience factor based on physical production.

Cost of Goods Sold

Over-all checks on the cost of goods sold will usually be applied to its major components such as material, labor, and overhead. It is in this area perhaps more than in any other that modern management controls abound, and in a well-run company the auditor will find a wealth of internally developed figures. The methods of measuring and controlling material, labor, and overhead costs will vary greatly, depending on the manufacturing processes and management's objectives; consequently, examples in this field must be general.

In the area of material costs, the cost per unit is one of the most significant. Variations in the cost per unit may be expected, and a sound explanation of them is of real value. They may be attributable to new methods of production, changes in material mix or material quality, changed rates of rejection and waste, changed prices, quantity usage, or manufacturing efficiency. Material usage may also be tied in with scrap generation and scrap sales.

Over-all checks on labor also may be best approached on a product unit basis. In a multiproduct enterprise a breakdown by departments may be desirable. Variations in labor cost may usually be accounted for by changes in efficiency, new production methods, learning curves, changes in pay rates, or special conditions such as abnormal set-up times, strikes, or overtime work. Other measures of over-all labor costs are periodic comparisons of average wage rates and production per man hour. When an incentive pay system is in operation, an effective check is achieved by reconciling production output with payroll.

The area of overhead accounting and allocation is one where a great diversity of methods may be found. Whatever method an auditor finds already in use, as long as it is reasonable, may be used as a basis for over-all checks. The absorption of overhead

under a standard cost system is another area of concern, since it has a bearing on the accuracy of the inventory and cost of goods sold. Comparisons of percentage of overhead absorption over the years may be helpful, and variations may be explained by changes in the volume of production.

Spending variances are another common cause of fluctuations in overhead costs. Whenever we compare an expense account with its counterpart in the prior period, we are in effect looking at spending variances. Over-all checks on spending variances must take into consideration the degree of variability of different expense categories. In the case of variable expenses, such as payroll taxes for example, changes in the volume of production may justify a change in the rate of expenditure whereas fixed expenses, such as depreciation, vary only slightly when normal changes in the production rate occur. Of course, many expenses are of a semi-variable nature and will vary with, but not in direct relation to, volume of production.

Another over-all check on overhead expenses is based on the general assumption (often quite true) that the percentage relationship of certain expenses to their total tends to stay constant within reasonable limits. The focus under this test is on deviations from established patterns.

In the general overhead group, depreciation is an expense that is particularly adaptable to over-all tests. Weighted average percentages may be developed for asset groups, the application of which will afford a reasonable basis to test the depreciation expense.

Gross Profit

Gross profit and its relationship to sales are among the most widely used over-all tests of the reasonableness of sales, cost of sales, and inventory. It is, however, readily apparent that fluctuations in gross margin must often be explained in terms of changes in sales or cost of sales, or in terms of a combination of these.

Comparisons of gross margin with those data published by trade associations or other public bodies should be made with great care but they can disclose comparative profitability. Thus, if the company has, over the years, maintained a profit margin that came close to that of its industry range, a sudden departure from that range will require an analysis of the reason for such deviation.

Other Expenses

The great variety of expenses falling under this category and the numerous methods that suggest themselves for their subjection to over-all tests make it possible to give only a very few illustrative examples.

The computation of salesmen's commissions in relation to sales when these commissions are paid on the basis of a percentage of sales is an obvious application of over-all tests. Less obvious, but equally useful, may be the use of a weighted average percentage when individual calculations would be too laborious or would involve a test of a higher degree of accuracy than is required. Salesmen's expenses may sometimes be expressed in terms of a percentage of sales or a percentage of commissions earned.

Where a company has a complex capital structure, composed of many issues of bonds and other instruments of debt and bearing varying interest coupons, the interest expense may be checked over all by an average cost of borrowing percentage.

The test of the relationship of bad debts to sales or accounts receivable, of maintenance expenses to gross plant, of pension expenses to pension reserves or company payroll, with adjusting refinements as needed, may all be significant and sufficiently accurate for the auditor to rely on them.

Other Tools for Over-all Checks

There are a number of methods used in measuring, pinpointing, and explaining over-all changes in the financial position and profitability of an enterprise. Frequently they will be found already in use by the client, and the auditor will test their compilation, derive his own conclusions, and gain insights from them. When they are not already available, the auditor should have little difficulty in compiling them from the large detail of figures available.

Comparative financial statements from year to year showing percentage changes, both vertically (i.e., the relationships of individual items to totals for each period) and horizontally (i.e., year to year) should disclose significant changes.

The proper measurement of cost and expense changes may be achieved by means of variable budgets which allow for the effect on costs of variation in volume of production or activity. As a practical matter, the time and effort required for the introduction of variable budgets mean that they will be available only if already established as one of the client's internal tools.

In conclusion, we should mention the Source and Application of Funds Statement as an important means of appraising the overall significance of changes in financial position. This statement has grown in popularity over the years and is included in the annual report of an increasing number of companies. In quite a few cases, and increasingly so, the auditor's opinion has been extended to include it. It affords an excellent bird's-eye view of the "where-got where-gone" story of the company's net current resources. If it were made out from the preliminary figures available before the audit is undertaken, it could prove to be a valuable aid in determining the areas requiring emphasis in the total audit effort. It also highlights the discrepancy between book profit and the total funds generated by operations. It focuses on major changes in fixed and other noncurrent assets and in debt and equity.

The above illustrations of the use of over-all checks, though by no means exhaustive, should indicate the wide scope of their application. It should be pointed out that comparison is one of the most common evaluative processes used in analyzing data and in drawing conclusions from the analyses. There are many bases of comparison. Comparisons may be made against a budget, a standard or a forecast, against the data of other companies, or against other published data. In addition to the above comparison, the auditor will develop his own historical comparisons with figures compiled over the years.

It is obvious that the most reliable figures to be used in comparisons are those developed from the company's own experience by either the controller's department or the auditor. Because the time that the auditor can devote to assembling and developing over-all control figures is limited, it is of utmost importance that he make as much use as possible of internally generated figures.

Considerable care should be exercised in the use of external figures for comparison purposes. The chief danger lies in the possibility that they may not be truly comparable with those generated internally. The sources of data published by companies, industry groups, professional, trade or industry magazines, or other public or governmental agencies are numerous, and many are sufficiently accurate to be valuable. However, to make comparisons meaningful, it is important to know the source, accuracy, and method of computation of published ratios, relationships, or average figures.

Figures and ratios that have been assembled over the years should be preserved by the auditor. The larger and more comprehensive the reservoir of data, the more valuable it will prove to auditor and client alike. Series of figures computed over a long period tend to smooth out the sharp ups and downs of unrepresentative years and provide a better yardstick when adjusted for normal growth. The best place to assemble these ratios and yardsticks and record the method of arriving at them is the permanent carry-forward file.

The integration of over-all checks into the auditor's program may best be illustrated by showing their uses in the different stages of the auditor's work.

During planning and audit program preparation, the conclusions arrived at from the application of over-all checks of prior periods are valuable in determining areas of the audit that need special attention. Also, if the audit is planned after preliminary current figures are available, the subjecting of these to some over-all checks may indicate areas requiring special attention.

The use of over-all checks during the examination has been illustrated throughout this article. The post-audit application of over-all checks involves a synthesis of all that has been learned during the audit. The product, in addition to being the basis of the auditor's opinion on the financial statements upon which he is to report, is an insight into and an understanding of ever-changing interrelationships that affect the business' financial strength, profitability and competitive position. It is in this area that auditing and management services meet, as indeed they should. A critical examination of figures, ratios, and data, and their comparison with similar data developed in the past can form the basis of searching and intelligent questions put to the client. Such questions and observations may be incorporated into a long-form report or discussed informally. Whatever form such a report takes, it may prove to be the beginning of a real opportunity to be of service to the client.

Summary

The use of over-all checks holds three important advantages: (1) it gives the auditor a broad view of the changing relationship of the client's composite financial picture—a view that is well correlated to the past and one that consequently increases both the efficiency and the effectiveness of his audit; (2) it provides the insight needed to give the client the full benefit of the auditor's

training and experience; and (3) it frequently reduces detail checking and thus saves audit time.

The tools discussed in this article are by no means exclusive to the auditor, nor were many of them originated by accountants. Indeed, they originated chiefly with the ultimate users of the auditor's report. By subjecting financial statements to some of the same tests used by the reader to gain an understanding of their significance, the auditor will be able to better serve those who rely on the presentation, usefulness, and full disclosure of his reports.

Former American Institute President Alvin R. Jennings presents a gift to Carman G. Blough at a recent party in his honor in New York. The occasion celebrated Mr. Blough's retirement as the Institute's Director of Research. He is expected to continue in an informal consulting capacity.

Inherent Weaknesses in Present Day Public Utility Accounting

By Walter R. Staub

One cannot usefully attempt to consider problems of accounting in regulated companies unless he is always consciously aware that, in the case of a regulated company, accounting performs an especial function and fulfills an especial need not present in the case of those companies which are subject to our natural economic laws of supply and demand.

Generally, in our free enterprise system, demand for a particular good or service creates an incentive to establish the capacity to supply it—this is what triggers the economic law of supply and demand. Obviously, operation of this law involves to a degree some duplicative effort and expense. While in a very narrow technical sense, this duplication might be considered an economic waste, it has been deemed a worthwhile cost to pay for the benefits which our society receives for the privilege of having its needs supplied through competitive effort. However, in certain areas, notably the public utility industry, the capital cost of supplying a particular service is of such magnitude that we cannot afford this waste, and in these areas we have deemed it wise to grant monopolistic privileges. Now in the case of enterprises in general, the public is able to exercise its influence over the price which it chooses to pay for goods and services through operation of natural economic law of supply and demand. Once monopoly has been granted, however, this influence largely disappears and thereupon there immediately arises the need for another form of control over prices to be paid. The method of meeting this problem is the government-sponsored regulation of rates by commissions or similar quasi-judicial agencies. In turn, these commissions must rely heavily upon proper accounting for costs and revenues as a basis for decisions as to prescribed rates which will be equitable both to the utility and the public. Thus rates are directly responsive to accounting determinations and this is the especial function that accounting performs in the case of regulated companies that is not present elsewhere.

This especial function early gave impetus to the promulgation of prescribed rules of accounting for regulated companies. It must

be borne in mind that many of these prescribed rules were first set forth in the latter part of the nineteenth century and the early part of this century. At that time there did not exist any set of generally accepted accounting principles, at least as we understand that term today; further, to the rather limited extent that financial statements were published, the great majority were not subjected to review and report by an independent auditor. Accounting rules upon which financial statements were then predicated thus tended to develop within companies and to be responsive to the needs and desires of management without too much regard to their usefulness or trustworthiness as a tool for other interested parties, including stockholders. Accountants, as a group, were keenly aware of the capacity which these conditions had to lead to the deterioration of proper accounting. Their efforts to bring into being a code of generally accepted accounting principles were not inconsiderable but of necessity the process was an evolutionary one and, therefore, slow. Indeed, as late as 1932, a special committee of the American Institute of Certified Public Accountants in cooperation with the New York Stock Exchange, recognized that, while certain broad principles had at that time evolved, choices of alternative methods within that broad framework of principles was so wide that chief reliance had to be placed upon the consistency of application of such procedures as a corporation chose to employ within a rather broad range of generally employed alternatives.

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It is quite evident that under these circumstances the rate regulation process essential in the case of public utilities and other regulated companies could not effectively function unless, at least for these companies, a code of procedures was laid down. This need, in my opinion, constituted quite sufficient justification for the prescription of uniform systems of accounts, especially at the time they were initially laid down, and, in all frankness, I think an exceptionally good job was done. However, while recognizing the apparent need for this prescription, we must also recognize its limitations. As was pointed out over twenty years ago, "Uniformity in accounting, particularly when prescribed by regulatory authority, has a tendency to 'freeze' rather than merely standardize accounting practice and to lead to a minimum standard rather than a maximum of good accounting practice. In other words, there tends to be stabilization at an approximate point of development rather than regarding it as but a taking-off point for further advance and improvement." To put this quotation in proper context, let me say that the author did not intend to impiy *no* change but rather that regulation tends to *deter*, or at least *defer*, recognition of evolving and changing views. I consider this "dragging of the feet" to be the principal factor underlying current weaknesses in utility accounting.

A further limitation inherent in prescribed systems of accounts must also be recognized. While accounting orders issued from time to time are not necessarily followed in rate proceedings, at least initially, nonetheless it must be considered that accounting practices prescribed by public utility authorities are primarily for use in the rate-making area and, as a result, can and probably at times do reflect attitudes not necessarily responsive to the needs of investors.

The evolutionary refinement of generally accepted accounting principles has considerably lessened the need for prescribed systems of accounts. It has also tended to emphasize a further inherent limitation. This stems from the fact that the operation, concurrently, of differing accounting philosophies impairs comparability of operations of utilities with the performance of companies in other fields. This need for comparability among industries as well as within a particular industry should be an important consideration in our constant endeavor to develop to the greatest extent feasible accounting principles applicable to all industries; in saying this, I am not advocating a single set of rules applicable in every instance.

A great impetus to the development of generally accepted accounting principles was furnished by the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934 which imposed, for the first time in this country, a requirement that financial statements of publicly owned companies be certified by independent accountants. I should point out that shortly before this—in 1932—the New York Stock Exchange formally decided to require that companies seeking listing privileges would have to follow the practice of having their financial statements audited.

To further the development of a formal body of generally accepted accounting principles, the Institute through its Committee on Accounting Procedure began, in 1939, issuing Accounting Research Bulletins on a variety of subjects. These bulletins have achieved authoritativeness because of the general acceptability of the conclusions expressed therein, and this authoritativeness has been recognized both within the profession and by the business community at large.

Some persons have asserted that these bulletins do not apply to regulated companies such as public utilities. I shall not argue the point here. In my opinion, these pronouncements cover regulated as well as nonregulated industries. If regulated companies are not covered, then we have been wasting a terrific amount of time with many of our clients, and in our Institute committees, on matters with which we need not be concerned. Certainly, in the final analysis, the bulletins *have* had a definite influence on public utility accounting. Possibly the most noteworthy example where a bulletin has caused a complete change in thinking on the part of public utility commissions is found in the bulletin issued in 1948 on the accounting treatment for pension costs based on past service. Prior to its issuance, practically all public utility commissions insisted that such costs or payments be charged to surplus or to income "below the line" but not as an operating expense, and refused to allow them for rate determination purposes. Following its issuance—and general acceptance—the commissions eventually adopted the recommended accounting.

Frankly, I do not believe the public utility companies—at least the great majority of them—wish to be considered "a special breed of cat," not subject to the accounting principles followed by industry generally—and as I have already stated, I don't think they are an exception.

I do not think we, as professional accountants, can quarrel with any decisions that a regulatory commission considers appropriate to make for rate-making purposes within the province of

its authority. However, I do believe we can and should object strenuously to the extension into financial statements intended primarily for investors, creditors, and the general public of those decisions which we believe to be contrary to good accounting. Prescribed accounting is not, per se, good accounting.

Perhaps another comment is in order at this time. Rate determination must be based in large part on the proper allocation or assignment of costs to a given period, and this is likewise one of the concepts underlying generally accepted accounting principles used for general financial statement purposes. If the aims are similar, why do we find so many divergencies?

I recognize, of course, that in some instances there may be conditions inherent in a regulated industry that call for treatment of items that is somewhat different from the manner in which the same items would be treated by a nonregulated company. For example, accounting for losses incident to abandonment of working plant, conversion costs, extraordinary storm damage losses, and interest on equity capital invested in plant construction may very well take a different form because of the differing impact of the items upon the regulated company's structure. Assuming that any such prescribed accounting carries with it compatible regulatory treatment for rate-making purposes, I would have no difficulty in accepting such prescribed treatment as being in "conformity with generally accepted accounting principles" under the broad concept of matching costs and revenues.

However, many of the prescriptions of regulatory accounting do not stem from circumstances such as I just briefly outlined and, at the same time, do differ from generally accepted accounting principles.

After this not too brief foreword, I would like to discuss some of the particular areas where I believe prescribed regulatory accounting practices are at variance with generally accepted accounting principles and where, from the viewpoint of the investing public and other interests than the rate-making regulatory commissions, the application of generally accepted accounting principles would result in more useful financial statements.

Currently, the principal areas of differences between prescribed public utility accounting and generally accepted accounting principles which are the cause of some concern are, in my opinion:

1. Degree of application of tax-effect accounting.
2. Accounting for the difference between corporate acquisition cost and original cost.
3. Treatment of certain extraordinary losses and costs.

I shall now briefly discuss each of these.

Tax Effect Accounting

There are many differing viewpoints as to how far tax-effect accounting should be applied and, as you know, this is one of the areas designated by the Accounting Principles Board for further research. However, I believe the broad principle of tax-effect accounting is now accepted by industry generally, and I happen to be one of those who believe in it—as they say—100 per cent. Accordingly, it is in this area of accounting that, in my opinion, many regulatory bodies have been laggard in recognizing the implications of the divergencies between tax accounting and financial accounting.

The Committee on Accounting Procedure first addressed itself to this problem in 1942 in a bulletin dealing with the treatment of unamortized discount on refunded bond issues. The committee recognized that where the discount was charged to surplus and the resultant reduction in income taxes was allowed to flow through to income, serious distortion could result. It therefore recommended that in such cases there should be charged to income an amount equivalent to the reduction in taxes which the refunding occasioned. Otherwise, the Committee stated ". . . the anomalous result would be produced that a loss recognized as such would have the effect of increasing the net income reported for the year." It also recognized that, in cases where the discount was carried forward as a deferred charge, to be amortized over the remaining life of the refunded issue, the amount so carried forward should be reduced by the amount of the income tax reduction which was obtained in the year of refunding.

In 1944 a statement dealing specifically with income taxes was issued which reaffirmed the rationale set forth in the 1942 statement, thus clearly indicating that those views were applicable to all transactions where absence of tax-effect accounting might give rise to distortive results. This thinking has again been reaffirmed in bulletins dealing with amortization of certified emergency facilities and with accelerated depreciation.

Many regulatory bodies have been strangely reluctant to follow the lead of the accounting profession and of business, generally, in recognizing the distortive potentialities of nonrecognition of tax-effect accounting. In some cases it is permitted, but with limitations; in other instances it is prohibited; in other cases it is ignored—at least officially, but with some exceptions on a case by

case basis—and all of this in an industry where the primary purpose of a uniform system of accounts is to achieve uniformity in accounting!

The most alarming amount of diverseness is in the treatment by various regulatory bodies of tax-effect accounting as related to accelerated depreciation and amortization—particularly the former.

The Federal Power Commission provides for so-called "normalization" of income taxes (i.e., tax-effect accounting) in its system of accounts, but makes its use optional. The optional provision may well stem from the provisions of the Federal Power Act which provides that where there is a conflict between State and Federal accounting requirements, the State takes precedence. However, the Act provides that the Commission may require reporting *to it* of accounting and other matters in such *form* as it may direct. The Civil Aeronautics Board, which first prohibited deferred tax accounting, now allows but does not require it. The Interstate Commerce Commission does not permit it at all. The Federal Communications Commission's systems of accounts contain no provision for tax-effect accounting, although the issue has not been completely reviewed by that Commission. All is not hopeless, however. In other areas of tax-effect accounting—such as items affecting income because of the tax effects of items charged or credited directly to surplus, the FCC has given approval of tax-effect accounting on essentially a case by case basis in order to prevent distortive results.

When we come to the various state commissions, we find all sorts of opinions. Some require or approve a charge to income where the adoption of an accelerated depreciation method results in a current decrease in income taxes payable with a consequent future increase in the taxes; others take the position that the charge to income for taxes should be limited to or measured by taxes imposed for the year under report—the "flow through" theory. Even in the case of those commissions which approve accounting for the so-called deferred taxes, there is an alarming difference of opinion as to how the credit should be handled. Some call for its inclusion in the equity section of the balance sheet as a form of restricted surplus, others require it to be shown as a reserve, and still others take the position that it should be treated in effect as an additional reserve for depreciation. Incidentally, the FPC classifies it as a credit in never-never land, neither a liability, reserve or restricted capital; again, this position may

have been taken because of the restrictions under the Federal Power Act. The Securities and Exchange Commission, so far, at least, has stated its position in characteristically unequivocal terms, and has ruled that the deferred credit cannot be treated as equity capital.

I shall not bother you with a state by state "count-down" as to the positions taken on tax-effecting accelerated depreciation. Speaking broadly, however, about three-fourths of the states have taken a position through accounting or rate-making orders, and of these, about two-thirds approve some form of tax effecting, while the other third approves only the so-called "flow through" method—that is, taxes are taxes. In one or two cases, one method is approved for accounting and the other for rates, in the same state! In the states where tax-effect accounting is permitted, there is diversity of treatment of the resulting credit; sometimes it is deducted from the rate base, other times not. Certainly all of this must lead not only to confusion in the interpretation of financial statements but also to uncertainty in the minds of management as to the best course of action to take when considering the problems of customers and investors.

As to industry generally, the question of tax-effect accounting with respect to accelerated depreciation methods has been pretty well settled by the issuance of Accounting Research Bulletin No. 44 (Revised). As you know, paragraph 8 of that bulletin dealt specifically with regulated companies and stated that, in the committee's opinion, tax effecting accounting should be permitted by commissions for both accounting and rate-making purposes—and I concur fully. However, the paragraph then went on to state that, where tax-effect accounting is not allowed for rate-making purposes it need not be followed for accounting purposes if it may reasonably be expected that any increased future income taxes will be allowed in future rate determinations. Personally, I do not have any objection in *theory* to the approach taken in Paragraph 8, but it certainly presents some very difficult practical problems. For example, there are those who question whether a commission will actually allow higher taxes paid in later years, and I must confess I am disturbed by a statement such as that made by the Illinois Commerce Commission—and I quote:

> It appears to this Commission that it would be merely a hopeful guess by a utility that a Commission some time in the future would allow for rate-making the payment of income taxes in excess of otherwise normal income taxes resulting from savings in income taxes in earlier years, which may have

been, in part or in whole, distributed as dividends. This Commission does not believe that *it may reasonably be expected* that such increased future income taxes will be allowed in future rate determinations. (*Union Electric Company* case, January, 1959.)

In the same tenor, we have the fairly recent action of the California commission (which favors "flow-through" accounting) in the *Southern California Water Company* case, where the commission disallowed the increase in taxes occasioned by deferments of taxes in earlier periods.

As was indicated previously, the Federal Power Commission permits tax-effect accounting, under certain conditions, with respect to accelerated depreciation. But it doesn't "follow through" in certain other areas. About a year ago I was chairman of a sub-committee of the Institute's Committee on Accounting Procedure which submitted certain suggestions to the FPC relating to a proposed revision of that commission's uniform system of accounts, now effective. As to tax-effect accounting, the sub-committee stated "The system of accounts should recognize allocation of income taxes to the extent deemed to be called for by generally accepted accounting principles in order to achieve a fair statement of operating results." It then went on to explain the differences between tax-effect accounting as recognized in the uniform system and as deemed generally called for under generally accepted accounting principles and pointed out that the major difference was in the extent of nonrecognition of negative allocations of taxes—these negative allocations, of course, stem from the recording of loss transactions without reductions by reason of the income tax savings to which they give rise. Naturally, in cases where the loss is charged to surplus, the reported figure of net income includes an apparent benefit by reason of the tax consequences of the loss which was treated elsewhere. There was to the best of my knowledge no justification advanced for the prescribed treatment either then or now, and incidentally no action was taken on the sub-committee's recommendation.

So much for tax-effect accounting! Let's go on to the next subject, which is

Original Cost

As a consequence of the speculative excesses during the "Twenties" and in order to protect consumers against utility rates based on inflated values recorded in property accounts, the concept of "original cost" was adopted by regulatory authorities. Now

this may strike you as a "stale" issue. That is not quite so. This concept still influences current transactions. No serious objection was raised by accountants to making available to regulatory bodies the "original cost" of physical properties for rate-making purposes, in addition to the actual cost of such property to the utility. However, there has been, and is currently, considerable objection to the position of some commissions, such as the Federal Power Commission, and the Federal Communications Commission, that their jurisdiction over books of account extends to the write-off of the excess of actual cost over original cost on various arbitrary bases, particularly as these arbitrary write-offs affect financial statements submitted to security-holders. The Supreme Court, in the *American Telephone and Telegraph Company* case in 1936, confirmed the authority of the Federal Communications Commission to require the recording of plant in the accounts at "original cost" but denied the right of the Commission to require the write-off of the difference between "cost to the utility" and "original cost" to surplus if such difference represented "value." The philosophy underlying the recording of plant acquisitions at "original cost" rather than "cost to the utility" with a write-off of the difference to surplus or amortization of such excess over arbitrary periods is alien to the accepted accounting principles which are predicated on cost accountability on the part of the reporting company and the allocation of this cost over the estimated useful life of plant in a systematic and rational manner.

Even though in many jurisdictions rates are not based solely on consideration of original cost but on a combination of factors which also include reproduction costs, interest requirements, provision for taxes, return on invested capital, etc., the concept of "original-cost accountancy" still persists, at times, with some arbitrary and capricious results. Witness a recent case where a former carbarn with a market value (based on competitive bids) in excess of original cost less theoretical reserve, was sought to be purchased by a non-transportation utility for a garage. The commission required "original cost" accounting. I personally know of another instance where the attempted imposition of "original cost" was the major influence in causing the purchaser to cease negotiations and to acquire alternative properties at a greater cost. Very obviously, this attitude constitutes a serious hindrance to efforts of companies to acquire needed properties on the most favorable terms, and if carried to extremes, could well result in higher rates to the users of a utility's services.

Extraordinary Losses

Occasionally, utilities sustain losses of plant capacity through unusual and nonrecurring events such as storm damage or the need to convert from one type of an operation to another as, for example, conversion of manufacturing gas facilities to those suitable for natural gas. In the case of nonregulated companies, the destruction, or the rapid obsolescence enforced by circumstances of the kind to which I have just referred, would lead to a charge-off of the plant in question, either to income or to surplus in the year of the event. In the case of utilities, however, it has been quite common for regulatory commissions to, in effect, approve the deferment of these so-called "losses." This, superficially, in any event, appears to be at variance with generally accepted accounting principles, but, as I briefly indicated earlier, upon closer examination I believe one may conclude that the divergency is more apparent than real. The nature of the operations of a utility requires a very large capital investment in plant. This investment is dedicated to the public use and the return which may be had on it is limited by the regulatory process and, except as it may be covered by insurance, the utility can do little to protect itself against loss of these dedicated facilities. Further, when we get into the area of technologically inspired obsolescence, it would not, in my opinion, be in the public interest to suggest that a utility use its monopolistic privilege to continue to dedicate facilities to public use when other facilities could more adequately, efficiently, and cheaply serve the public. On the other hand, it is unreasonable to expect the owners of the enterprise to entirely bear the burden of the risks entailed by these possible circumstances unless, at the same time, commissions were to allow a considerably greater rate of return to compensate for this risk factor—a course which again perhaps would not be in the public interest. Consequently in many instances it has been the practice of utility commissions to permit, for rate-making purposes, appropriate operating charges to cover this type of expense, either by means of allowing the deferment and amortization of incurred cost or by allowing on some arbitrary, but nonetheless apparently reasonable basis, annual provisions to a reserve account. I have no difficulty in accepting accounting which conforms to rate determinations in such circumstances—the decision of the regulatory commission to compensate the utility through rates has the effect of converting the so-called "loss" to an asset in the sense that it becomes a charge to be "costed out" against future revenues. Of course—

and I would like to emphasize this—where such recoupment is not permitted by regulatory authority through adequate rates, any type of deferment or annual reserve would simply be normalization of income and, consequently, could not be considered as in consonance with generally accepted accounting principles.

Other Areas

I shall mention only briefly a few other areas of public utility accounting where the divergencies from generally accepted accounting, though of lesser import, are nonetheless not without consequence. Among these are such items as miscellaneous charges and credits to surplus, treatment of charitable donations, and certain balance sheet and income statement classifications.

Provisions in uniform systems requiring certain specific items to clear through surplus, regardless of their amount, represent a failure to update accounting requirements to present-day generally accepted practices. In its comments on the revision of the Federal Power Commission's Uniform System of Accounts, the subcommittee to which I previously referred stated the following:

> The System of Accounts requires charging or crediting directly to surplus, rather than through income, transactions of specified natures, regardless of amount. Under generally accepted accounting principles, there is a general presumption that all items of profit and loss recognized during a period should enter into the determination of net income of that period; the only exceptions are *material* items not specifically related to the typical operations of the period. The reasonableness of this presumption becomes apparent when we consider the repetitiveness of small adjustments of prior year items, etc. We believe that conformity of prescribed accounting with generally accepted accounting practices in this area would be quite desirable and do not see how it would conflict in any way with regulatory objectives.

This comment is equally applicable to the uniform systems of accounts prescribed by the Federal Communications Commission and by other regulatory authorities.

There is a wide divergence of opinion among regulatory commissions as to the propriety of recognizing charitable contributions and donations as items of expense for rate-making purposes. For example, in New York, public utilities are not permitted to make contributions and record them as an operating expense, but rather they must be treated as "below the line" items. A number of other commissions have prescribed similar accounting, while, on the other hand, other commissions—fewer in number—have permitted their inclusion for the determination of rates. While failure to permit the deduction of charitable donations as an operating expense is undoubtedly within the scope of regulatory authority,

it certainly seems inconsistent with present day realities, which impose a moral obligation on business enterprises to support worthy causes. Under the circumstances the practice in other industries of treating such donations as ordinary operating expenses, in my opinion, constitutes sound, realistic accounting.

Failure of some uniform systems to require classification of long-term debt maturing within one year as a current liability represents another failure to conform to generally accepted practice.

As accountants, we must concede that regulatory bodies have the right to determine when and in what manner costs may be charged against revenues for purposes of determining rates. However, it is incumbent upon us to recognize that the adoption of these requirements for reporting purposes has resulted in divergencies from generally accepted accountingprinciples which sometimes seriously affect the comparability of utility reports within the industry itself and with those of companies in nonregulated industries.

As I indicated earlier, I find it difficult to understand why, in the long run, accounting principles acceptable for sound financial reporting cannot be compatible with those required for rate-making purposes.

How can we lessen or eliminate these current differences in accounting practice? Certainly the practice of Institute committees of submitting recommendations to regulatory bodies in response to invitations to comment on proposed rule making, changes in uniform systems, etc., has not been particularly effective. I believe a more positive approach is required, such as the establishment of a closer working liaison between appropriate Institute committees and the accounting committees of the various federal regulatory commissions, the NARUC (National Association of Railroad and Utilities Commissioners) and the EEI/AGA (Edison Electric Institute-American Gas Association). As you know, a special committee of the Institute, under the chairmanship of our moderator—Mr. Murphy—established such a close working relationship with the Interstate Commerce Commission about two years or so ago, and I believe the example there set could well be followed.

In addition, in my opinion, our reports as auditors should disclose the results of any material departures from generally accepted accounting principles, even though such departures are occasioned by prescribed accounting. This would serve to enhance comparability of utility reports with those of other industries and might even be influential in fostering the use of generally accepted accounting principles by regulatory commissions in their accounting prescriptions.

Tax Planning for the Closely Held Business

By Sidney Kess

Closely held businesses, large or small, are in general subject to the same tax rules as more widely held businesses. Their opportunities for taking advantage of some of these provisions are often far greater, however. This article reviews some of the tax saving opportunities which have particular application to closely held corporations.

Thin Capitalization

The owners of a closely held business obtain certain tax advantages by making part of their investment in the form of a loan rather than as a capital contribution. The interest on the loan is deductible by the corporation whereas a dividend payment is not. Repayment of the loan out of the company's earnings results in no tax to the owners; a partial redemption of stock out of earnings would probably constitute a dividend, taxable as ordinary income, except for the limited exclusion and 4 per cent credit.

The Treasury, recognizing that many seek to exploit this advantageous tax treatment unfairly, may try to treat the loan as capital. If the Treasury is successful, the result is that the interest deduction is disallowed to the company, and the repayment of the loan is treated as a taxable dividend to the owner.

One of the tests that the Treasury uses to determine whether the loan is to be treated, instead, as a contribution of capital, is the ratio of the stock to the indebtedness. Recent court decisions indicate that the court's current policy is to minimize the "thinness" test in favor of an evaluation of the company's "intent." In practice, however, a ratio of debt to stock limited to 5–1 is generally considered safe.

In *Brake & Electric Sales Corporation* v. *United States*, D. C. Mass., 7–16–60 the court held that the "loans" were not true loans and therefore the interest deduction was disallowed.

In that case Mr. X transferred $20,000 to a newly formed corporation in exchange for stock. Subsequently he transferred assets with a book value of $90,000 in exchange for a $90,000 note. Despite the fact that the ratio was 4½ to 1, and the indebtedness was not excessive, the court disallowed the interest deductions. The court felt that they were in the nature of a permanent investment.

In *Zephyr Mills, Inc.*, T. C. Memo, 1959–181, *aff'd.*, F. 2d. (U.S.C.A-3) the court held that the loan to a corporation by a nonstockholder was not a valid debt, and the interest deduction was disallowed because the lenders were close relatives of the stockholders:

> The Company had a capitalization of $500. Its working capital came from loans by the sole stockholder and from related parties, including a family trust. The Tax Court refused to recognize any of the loans from the trust as valid debts. The court was not concerned that the creditor was not a stockholder, since all the parties involved were closely related.

Thus it can be seen that the thin capitalization problem can not be avoided by having relatives of the stockholders do the lending.

A company which is concerned about its ability to "document" the validity of its debt should consider repaying the debt over a period of years rather than all at once. In this way, the risk of dividend treatment is minimized. The company should not become complacent if the interest deduction is not questioned upon examination of its returns, as such allowance does not foreclose the Treasury from asserting an additional tax is due from shareholders upon a subsequent distribution in payment of the "debt."

Planning for Tax Benefits from Losses

Where a business is extremely speculative and the risk of loss of capital is high, the tax status of such a potential loss should receive special consideration. Under the general rule, losses on

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sale or worthlessness of both debt and stock are capital losses to individual investors. Such losses are deductible only from capital gains and up to $1,000 annually from ordinary income of the year of the loss and the five succeeding years.

Limited ordinary loss deductions are available, however, on sale or worthlessness of stock in a "small business corporation" which meets certain requirements of the Internal Revenue Code. See L.R.B. & M. JOURNAL—*Tax Supplement* for October, 1958. As this ordinary loss treatment extends only to stock and not to debt, the owners must compromise between a "thin incorporation" which permits withdrawal of capital tax-free, and a capitalization which maximizes the stock on which an ordinary loss deduction is allowable. The type of "small business corporation" discussed here should not be confused with an "electing small business corporation" which the Code treats essentially as a partnership and which also is an attractive form of organization for some business enterprises which can meet the stringent and detailed qualifications and limitations the Code imposes upon them.

Timing of Dividends

Where a corporation has a deficit (on a tax basis), proper timing of distributions to shareholders can save them substantial amounts of tax. Distributions are taxable to the shareholders only if they are out of either (1) earnings of the current year or (2) accumulated earnings (since February 28, 1913). Excess distributions are not taxed, but are applied against the shareholder's basis for his stock. Once such basis is exceeded, the distributions are generally taxable as long-term capital gain.

Maximum advantage of these rules can frequently be taken by staggering distributions between taxable years, so that larger distributions are made in alternate years.

Example:

Company A, a calendar year corporation, has a deficit at the beginning of 1960 of $100,000. In 1960, the company has earnings and profits of $20,000. If a distribution of $20,000 is made in 1960, it will be fully taxable to the shareholders. However, if a distribution of $40,000 is made in 1960, while the first $20,000 would be a taxable dividend, the balance of $20,000 would be tax-free. The additional $20,000 might very well represent the normal dividend for 1961, paid in advance. If the earnings for 1961 were $20,000, a distribution of $20,000 in that year would be fully taxable. By omitting any dividend in 1961 and doubling the dividend for 1962, the cycle can be continued with half the dividends nontaxable until the deficit in accumulated earnings is used up by application of the earnings of the years in which no dividends are paid.

Other Dividend Questions

In a recent Tax Court case, *Mark G. Anton et ux.*, 34 T. C. 842, the owners of a closely held company decided to distribute a "deficiency dividend" in order to avoid an agreed personal holding company tax. A gift of the stock to the children was made to avoid a dividend tax in their own high brackets. The dividend was declared on April 17, payable to stockholders of record May 10. On May 9, a gift of the stock was made to their children. The Tax Court held that the dividend was taxable to the parents because under state law their right to receive it was vested upon the declaration. It is not clear how the court would have ruled if the gift of the stock had been made prior to the dividend declaration.

Frequently a stockholder-officer of a closely held business uses the corporation's funds for his own personal purposes. In *Frederick Ackerman et al.*, T. C. Memo 1959-164, the owner of a closely held business withdrew funds from the corporation. Notes and other evidences of indebtedness were not given, nor was interest charged on these withdrawals. The Tax Court held that these withdrawals were a dividend to the stockholder.

Stockholder-officers of closely held corporations have discovered that Revenue Agents are combining an audit of the Corporation's tax return with their personal returns. Frequently the travel, entertainment, and other expenses paid to them by the firm are disallowed as deductions to the corporation and treated as a dividend to the shareholder to the extent of earnings and profits. In that case a dividend received credit should be permitted for the disallowed travel and entertainment.

Several court cases have been handed down recently illustrating how taxpayers have attempted to withdraw profits in the form of disguised dividends.

> In the *Homemade Dairy Company* case, Tax Court Memo 1960-109, a company sold milk and milk products to its employees at a discount. Three of the stockholder-officers received the products free. The court held that the deduction should be disallowed on the ground that it was in the nature of a dividend.

Attempts to minimize the double impact of taxes on the corporation and the shareholder require careful planning by the businessman and his accountant.

Profit Retention by the Corporation

Closely related to the dividend problem, is the amount of profit which the corporation may retain without any penalties

being assessed against it. Rather than pay a high tax on dividend income, the owner-shareholders of a closely held business frequently retain the earnings in the business. To offset the temptation to avoid tax in this manner, a penalty surtax is imposed on income unreasonably accumulated by a corporation to avoid a tax on its shareholders. If the corporate taxpayer can show that the accumulation was justified because of reasonable business needs, the penalty tax is not imposed.

The burden of proof of unreasonableness is shifted to the Commissioner if the taxpayer files a statement sufficiently explaining the grounds for the accumulation. Unfortunately, the Tax Court has sometimes appeared to have ignored these Code provisions (see *Pelton Steel Casting Company,* 28 T. C. 153, *aff'd* 251 F. 2nd 278). The First Circuit in a recent decision seems to have reversed the Tax Court's position in this area.

A closely held automobile agency accumulated over $300,000 in earnings without the payment of a dividend. The owner-president did not withdraw a salary for many years. The company made substantial loans to him. Government agents contended that these factors together with investment in unlisted securities pointed to an improper accumulation. The company filed a statement setting forth what they believed to be reasonable grounds for the accumulation; one reason was that if the company did not comply with the manufacturer's demand to enlarge its facilities they would lose their agency. The lower court held that this was not a reasonable purpose and therefore the company was liable for a penalty tax. *Young Motor Co.,* 32 T. C. *rev'd.* First Circuit Court of Appeals.

Despite the corporation's strong showing in the area of business need, the taxpayer still did not answer the question of tax avoidance, a question on which the taxpayer had not shifted the burden of proof. The basic question, the court said, is an *intent* to avoid the shareholder tax. However, the question of reasonable needs of the business should not be ignored. The court felt that the business needs might be the most important factor in deciding whether the corporation was trying to avoid a tax on its shareholders. In most surplus accumulations there will be shareholder tax savings, but that does not mean that the primary purpose is tax avoidance. All other relevant factors must be examined before a court finds that the taxpayer's purpose was improper. This case was reversed on appeal and remanded to find a primary purpose of the accumulation in view of all the facts.

A closely held business will have no problem on the first $100,000 that is accumulated. No questions are asked by the Treasury. However, if the accumulated earnings exceed $100,000,

it is important to review the capital structure to see whether a dividend should be paid out.

Some of the factors to which the courts give weight in determining whether accumulations are reasonable are:

1. A planned enlargement, modernization and replacement of facilities which may require accumulation of income to finance such expenditures. The agent and the court usually have the benefit of hindsight to guide them, however, so that nebulous plans which are not carried out have little evidentiary value.

2. Maturing liabilities which may require additional funds.

3. Noninterest-bearing loans made to a shareholder for his personal benefit (e.g., *Young* case). This tends to indicate an unreasonable accumulation.

4. The acquisition of assets which are unrelated to the corporation's business need, is an adverse factor. For example, in the *Young* case, the purchase of unrelated securities was one of the factors which the Internal Revenue Service said pointed to an improper accumulation. Earnings may properly be accumulated to go into a new line of business.

5. The prior dividend policy. A history of substantial dividends paid over a period of years would indicate that the corporation is not being availed of to reduce the tax liability of its shareholders.

The penalty tax exerts considerable influence on the company's dividend policy. Proper planning involves avoidance of imprudent dividends, balanced against unreasonable risks of a penalty tax. Sound tax planning requires the company to establish adequate documentation before any question is raised by the Treasury.

Use of Multiple Corporations

Closely held corporations frequently form new corporations to handle parts of the company's operations. Besides spreading the possible liabilities, the income is spread over several entities which results in a tax advantage because an additional surtax exemption is obtained for each new corporation, and thus a saving of $5,500 in taxes ($25,000 taxed at 30%, not 52%) for each new corporation may be obtained. In addition, each corporation is entitled to the $100,000 penalty surtax exemption and is a separate unit for determining the size limitations on small business corporations, losses on the stocks of which may qualify as ordinary deductions.

Recognizing the tax saving reasons for forming several corporations, Congress enacted several provisions designed to prevent abuses. The division of a corporation is prohibited taxwise if the major purpose is to obtain the extra $25,000 surtax exemption or the $100,000 accumulated earnings credit. The Treasury also has authority under certain circumstances to disallow deductions and

credits if the principal purpose for a corporate acquisition is to evade or avoid federal income taxes. Finally, the Treasury may reapportion income and expenses of the various corporations under common control unless all dealings between the corporations are fair and on an arm's length basis.

Two recent cases denied the surtax exemption.

In *Aldon Homes, Inc.*, 33 T. C. 582, a corporation initiated the construction of a large housing development. Subsequently, numerous related corporations were organized. Each one of the related corporations was controlled by one or more stockholders of the original corporation. The property was divided and then transferred to the related corporations. The actual construction was completed for them under contracts with another corporation controlled by Company A. All the sales were handled by one realty company, and the development was advertised as a unit. The court passed all the income to the original corporation because the related corporations carried on no independent income producing activities. The court said that the related corporations served no functions except to split the income from the development of the entire tract.

In *James Realty Company* v. *United States*, 176 F. Supp. 306, *aff'd* 280 F. 2d 394, CA-8, additional surtax exemptions were disallowed. The taxpayer organized 9 separate development corporations. Lots were transferred to these development corporations. Houses erected for the development companies by the construction corporation were sold by the sales corporation. The net effect was that 11 surtax exemptions of $25,000 each were created. Profits were kept around $25,000 a year and subject to a 30% rather than 52% tax. The Treasury and the courts agreed that the principal purpose of setting up the development corporations was to avoid taxes. Therefore, the $25,000 surtax exemption was disallowed.

A new weapon is being used to attack the real estate developers who operate through several corporations. The Treasury is claiming that the entire group of corporations is really one association and taxable as a corporation. The harshness of this approach is that the taxpayer in addition to losing $25,000 surtax exemption may possibly be forced to pay a penalty tax for failure to file a timely corporate return.

Taxpayers can learn from these cases that it is very important to establish business reasons (aside from tax savings) for the creation of the new company. These reasons must be available, should the company be questioned.

Planning for the Death of the Owner of a Closely Held Business

The most successful businessmen frequently neglect to plan for their family in the event of their death. Planning by the man who knows his business and its problems may result in substantial tax savings and a reduction of "headaches" for his family. Typical problems which might be considered in advance include: How

much should the widow receive from the company? If the surviving shareholder is to continue the business, how much should be paid for the stock? Where would the funds be obtained? How should the shares be valued? Where can funds be obtained to pay potential estate taxes?

These are very real problems for the owner of a closely held business. The accountant, with his specialized tax background in these areas, can offer a valuable service to his client.

If the owners of the business agree in advance to voluntary death benefit payments for their widows, each of the owners' families stand to gain tax-wise in the event of their death. At one time death benefit payments made *under contract* by a company to the survivor of an employee were excludable up to $5,000. The remainder was considered part of the gross income. Voluntary payments as well as payment under the contract are now excludable.

Assume that a company pays an employee's widow $10,000 as a death payment. Is the payment in excess of $5,000 income? The first case to be decided under the new code (*Reed*, W. D. Kentucky, 177 F. Supp. 233, *aff'd* 277 F. 2d 456 C.A.–6, held that an entirely voluntary payment of this kind was completely excludable. The court stated that the mention of the $5,000 exclusion did not in any way change the prior law.

The judgment in the *Reed* case though followed in *Cowan* v. *United States* 8/25/60 D. C. GA (appeal dismissed C.A.–5) should not be taken as the final word in this area. Several courts have recently decided similar cases in the opposite way (see *Rodner*, 129 F. Supp. 233, *Pierpont;* 35 T. C. No. 10, and the dicta in *Bounds* v. *United States*, 262 F. 2nd 876).

The Commissioner has said that the decision of the Sixth Circuit Court of Appeals in the *Reed* case is contrary to the Internal Revenue Service's position and will not be followed in similar cases, although review of the *Reed* case by the Supreme Court will not be requested (T. I. R. No. 252).

Another problem facing the owner of a closely held business is the disposition of his interest in the event of his death. Usually his main source of wealth is his interest in the business. The objective of most owners of a closely held business is to protect one another, i.e., the survivor acquires complete ownership of the business. The second concern is that the decedent's family will receive a fair price. (This is particularly important where the stock does not have a ready market.) Finally, they wish to avoid valuation problems for estate taxes. These objectives may be accomplished through a carefully drafted buy-sell agreement.

The Service states that there are two requirements that must be met in order for the value in the agreement to stand up for estate tax purposes. One is that the decedent must not have been able to sell his interest at any price he decided on during his life. Secondly, the valuation agreement must be arm's length.

In *Ralph W. Davis, Exr.* v. *United States*, D. C. Utah 3/30/60, a father and his son were 50-50 partners in a business. The partnership agreement provided that the survivor could buy the decedent's interest for 25% of the net value of the partnership assets. One reason for the low price was to enable the survivor to buy the interest which he would otherwise be unable to pay for at the full value. The court held that this was a valid and enforceable agreement. The Treasury's claim that the interest should be valued at twice the amount was denied.

In another case, three brothers owned a closely held business. They entered into a buy-sell agreement at the time one was incurably ill with cancer. The brothers could not sell their ownership interest during their life. The Tax Court allowed the price set in the buy-sell agreement for estate tax purposes. This was true despite the fact that the sick brother died soon after the agreement was executed.

The Treasury has been attacking the corporation buy-sell agreements through various routes. In some instances it has attempted to tax the outgoing or remaining stockholder with a dividend tax on the payment. The latest Treasury strategy has been to attempt to apply the accumulated earnings penalty tax where the corporation buys out a stockholder's shares. However, even if there is a buyout the taxpayer may still be able to show that the funds were accumulated because of good business reasons. In *Barrett Hamilton, Inc.* v. *United States*, F. Supp.—(D.C. Ark., October 8, 1959), the widow's shares of a closely held business were redeemed. The Treasury sought to impose a penalty tax for the open years. The court refused to uphold the tax. The facts indicated that the company paid liberal dividends, had good management growth, and skill in the business.

Conclusion

During the various stages of the organization and the operation of the business, there should be a review of the capital structure and form of organization. Changing needs, changing tax rates and future growth require constant attention. Tax-wise planning for the payment of dividends and the pros and cons of withdrawing funds through the salary or dividend route should be considered annually by the businessman and his tax adviser. How much the company can safely accumulate in light of its business needs may be an important question for some businesses.

Financial and estate planning for the owner of a closely held business is a frequently neglected but vital subject to explore. All businessmen need advice in this area. The accountant is in a unique position to save the owner funds during his life. He can also provide valuable advice as to how his client can most effectively achieve his objectives with respect to his family's long-range security. The accountant, as the tax adviser of the closely held business, can best serve his client's interests by expanding the "tax services" he renders.

Taxation of International Operations

By James J. Mahon

The following article is based on testimony before the Ways and Means Committee of the House of Representatives. Mr. Mahon's statement was presented on the last day of the hearings on the legislation discussed below.

We have been observing the testimony here on and off all week. Therefore, in the interest of avoiding repetition, I will confine my statement to that area in which I believe our knowledge and experience can contribute the most to these hearings—and that is the compliance and administrative problems that I envisage would result from the introduction of an unnatural and strained concept into our tax system.

In order to lay a little groundwork for this, let me explain briefly how our international accounting firm works.

Coopers & Lybrand operates in 24 countries. Among other things it examines and reports upon financial statements of clients' branches and subsidiaries which are located in countries foreign to that of the parent company. Since the principal capital exporting countries are the United States, the United Kingdom, Germany, the Netherlands and Switzerland, it follows that most of this international work at the present time originates in overseas investments made by parent companies located in these countries. Of necessity the work is performed in conformity with the applicable practice standards both in the respective foreign areas and in the country in which the parent is domiciled. Thus, examinations of financial statements of foreign subsidiaries or branches of an American parent company, for example, are designed to conform both to:

(a) Generally accepted accounting principles and auditing standards in the United States (which are required for purposes of consolidation with the parent company; and to comply with requirements of the several stock exchanges and the Securities and Exchange Commission); and

(b) Generally accepted accounting principles and auditing standards in each of the respective *foreign* countries, as are required to report on the financial statements in accordance with local statutory requirements.

The point I wish to make in describing what we do is that both tax and financial accounting principles and auditing standards

differ throughout the world—not necessarily for better or for worse—they simply differ. And American, United Kingdom and Swiss companies for example, operating abroad, are subject to local requirements and conventions in the foreign countries in which they operate—as well as to those prevalent in their home country.

I believe that these differences would constitute an almost insurmountable obstacle to the *effective* compliance with and enforcement of the Treasury's proposal to tax U. S. stockholders and particularly individual shareholders currently on their shares of undistributed earnings and profits of so-called "controlled foreign corporations"—even if such legislation were to be found desirable on other and more fundamental grounds, such as its effect on the United States' balance-of-payments, and its domestic economy and foreign policy.

Proposal would tax one entity on the income of another

I refer to the concept as unnatural. This is because it would impose a tax on one entity, based on the income of another—and this is fundamentally inconsistent with the established U.S. tax

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principle that income is not taxable until actually or constructively received by or accrued to the taxpayer.

It is true that there is some precedent for this concept in the foreign personal holding company provisions of our Internal Revenue Code; but there its application is safeguarded by a relatively narrow definition of personal holding company income, the extensive stockholding control requirements, and the widely recognized alter ego nature of the incorporated personal pocketbook. Therefore, that application of the concept can be viewed as an exception—undoubtedly a justifiable one; but nevertheless an exception to the fundamental and overriding principle upon which our income tax is based.

To expand the concept to the imposition of a tax on a 10 per cent U.S. stockholder's share of the undistributed current income of a foreign company which may be engaged in manufacturing, merchandising, mining, or any of the other multiple activities that are commonly engaged in by business and industrial corporations, is, I repeat, inconsistent with the established basic criterion for U.S. income taxation, that the only proper base for taxation is income—and an unrealized increment in the value of corporate stock or other property, to my knowledge, has never been held to constitute income.

Now, if the suggested practice of taxing 10 per cent U.S. stockholders on income of foreign business corporations can be justified by reference to the relatively narrow foreign personal holding company provisions as precedent, then even further departures from our established principles of income taxation are possible—and in the natural course of events most assuredly will follow. Indeed, one natural extension of the concept conceivably could be to tax U.S. stockholders on their share of undistributed income of U.S. corporations; or to tax the annual increments in value of real estate held, et cetera.

Perhaps a good case can be made for such extreme departures from present principles—but I, for one, wouldn't wish to see us unconsciously or unwittingly inching or drifting in this direction. Aside from the more philosophic justification for our present principle that income is not taxable until actually or constructively received by or accrued to the taxpayer, it finds support in the very practical consideration that the taxing of income or increment before its receipt or realization involves the raising of funds to pay the tax.

Therefore, Gentlemen, I urge that we proceed most cautiously before introducing into our income tax system an essentially unnatural and alien concept of income.

I also have referred to the proposed legislative concept as "strained." The reason for this is that the proposed legislation would base the tax of the American stockholder on the "earnings and profits" of the foreign corporation. Undoubtedly, the Treasury's reason for proposing to use "earnings and profits" as the proposed tax base is in order to harmonize the proposed new provision with existing provisions relating to the deemed-paid portion of the foreign tax credit; and, of course, "earnings and profits" *is* established and has long been used as a factor in determining this. However, even though "earnings and profits" of foreign companies has been a reasonably workable factor in computing the foreign tax credit, I do not believe its use should be extended and broadened to that of a base for a direct annual tax on U. S. shareholders—and particularly individual shareholders. This would be both a radical change in use, and a substantial broadening in application. And "earnings and profits" of a foreign company simply has too many infirmities to be relied on for this purpose—and this, Gentlemen, is an important factor that so far has been only obliquely referred to in these hearings.

"Earnings and profits" is a U. S. tax accounting concept. In addition to its use in determining the amount of foreign tax applicable to dividends paid by a foreign corporation, it is also used more commonly in determining the taxability of dividends paid by a *domestic* corporation. (As applied to foreign dividends the Code uses the terms "accumulated profits" and "profits from all sources whatsoever" but all three terms are generally accepted as being synonymous.)

Definition of "earnings and profits"

Now, although the Code prescribes the effect on earnings and profits of certain transactions *neither the Code nor the regulations contain a comprehensive definition of "earnings and profits" and consequently there remain many unsettled questions regarding its determination.* In general, earnings and profits are computed by reference to the method of accounting that is properly used by the taxpayer in computing taxable income. Taxable income is the starting point in such a determination—and this necessarily contemplates the basic principles of income determination under the U. S.

Internal Revenue Code, including the basis rules for determining gain and loss; and it also contemplates the various subsidiary alternatives or elections that are or have been availed of by the taxpayer in computing its taxable income under U. S. law such as the LIFO versus the FIFO inventory pricing method; the declining balance versus the straight line depreciation method; the percentage of completion versus the completed contract method; the installment basis versus the accrual method, and so forth. And to taxable income is added income that is exempt from tax such as tax-exempt interest, certain life insurance proceeds, a refund of federal income tax or any similar item of income that is excluded by statute from taxable income. And from the total so determined are deducted unallowable deductions such as capital losses in excess of capital gains, contributions in excess of the statutory limitation and the federal income tax itself—all of which, while not deductible in computing taxable income, actually have depleted the net assets of the company.

Now, sometimes it is necessary in determining earnings and profits to dig back to the formation of the corporation to establish the tax basis of certain assets. I might say that I have participated in accumulated-earnings-and-profits determinations that required investigation into records back into the last century—in two cases back to the 1820's. Let me add that this wasn't simple but at least we had U. S. income tax returns from 1913 to aid us—and the records generally contemplated United States accounting principles. Moreover, they were in English!

Now, the determination of earnings and profits of a *foreign corporation* involves the application of the same U. S. tax accounting principles but it is further complicated by the fact that the U. S. concept of "taxable income" is nonexistent as a starting point and therefore must be separately determined; the accounting principles generally used differ widely from those recognized in the United States and, more often than not, the records are in a foreign language.

Now let me point out some of the complexities of using "taxable income" of the foreign corporation in computing earnings and profits. As I have said, taxable income is a U. S. tax concept. But the foreign company rarely is subject to U. S. tax; it has never filed a U. S. corporate tax return and so, in the ordinary course of events, it will not have determined taxable income under our concept. The income reported for foreign tax purposes and upon which the foreign income tax is based is rarely very helpful.

This is because the concept or definition of taxable income varies from country to country and in any event will differ from that in the United States. For example, in the depreciation area, a recent study of the tax depreciation allowable in the United States as compared with several other countries on a typical piece of production equipment having a 15-year life, revealed that "in Japan and the United Kingdom, the possible first-year write-off exceeds 50 per cent of cost. In Sweden and Italy it exceeds 30 per cent. The corresponding figure for the United States is 13 per cent. (Also) . . . the United Kingdom and Sweden permit a recovery of more than 70 per cent of cost in the first three years of service life. Japan and Italy allow more than 60 per cent. The U. S. equivalent is 35 per cent."* In France a write-off of 58 per cent of the cost of new machinery and equipment over the first three years of life of a 10-year asset is now permitted. In Germany a maximum statutory depreciation rate of 25 per cent was recently reduced to 20 per cent. And in the Netherlands, depreciation allowances recently have been adjusted so that the depreciation on certain machinery is allowed to the extent of 110 per cent of the cost.

In at least *some* of these cases it is safe to say that the depreciation allowance will differ substantially from depreciation allowable or sustained under the U. S. concept which of course must be used to properly determine earnings and profits—adjustments must be made for these differences.

Moreover, the *bases* for computing depreciation in some countries will vary from the U. S. concept of historical cost. This is particularly true in countries that have had a currency revaluation. France, Austria and Brazil are examples. In these cases depreciable assets usually have been revalued upwards on the basis of official coefficients—and subsequent depreciation is permitted to be based thereon. As so revalued, the carrying value of such assets is rarely susceptible of easy conversion into the equivalent of dollar historical cost.

Indeed, bases for computing gain and loss generally may vary in foreign countries from those determined under the U. S. Code.

Inventory valuation methods also differ among various countries. An exaggerated form of LIFO is used in France, and various types of inventory reserves are permitted in several other countries.

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*Capital Goods Review No. 44; Machinery and Allied Products Institute—as described in the *Journal of Accountancy*.

Accounting—principles and practices

These are a few of many examples of how taxable income in various countries differs from that determined under U. S. tax law—and illustrate why income reported for foreign tax purposes is not very helpful in computing earnings and profits.

Moreover, just as tax accounting principles and practices in the United States have a strong influence on financial accounting practices and the maintenance of records here—so, too, do tax accounting practices in other countries strongly influence the record keeping there. For example, the LIFO method of valuing inventories is rarely used for accounting or financial statement purposes in the United Kingdom because it is not permitted for tax purposes. However, the exclusion of fixed overheads from inventory *is* a prevalent accounting practice there since it *is* permissible for tax purposes. And debt discount and expense usually is written off when incurred—and not amortized over the term of the debt. These and other such differences between accounting principles in foreign countries, and those generally recognized in the United States, also add to the complexities of determining earnings and profits of a foreign company.

Now, I have pointed out that "earnings and profits" is already established as a concept and has long been used as a factor in determining the deemed-paid portion of the tax credit applicable to foreign dividends received by U. S. corporate stockholders. In my experience the determinations made by U. S. tax accountants in the main have been quite fair and reasonable. This is particularly so where foreign subsidiaries are wholly or near- wholly owned by U. S. parent companies, since the U. S. parent invariably exercises sufficient accounting control over the subsidiary in maintaining collateral records etc. so that the subsidiary's net income can be adjusted to reflect earnings and profits under the U. S. tax concept—although admittedly the accurate determination of earnings and profits invariably becomes more difficult where effective U. S. control and direction over foreign accounting is diminished by reason of less-than-controlling ownership in the foreign company and the resultant participation of the foreign co-owners in the foreign company's management. Nevertheless, despite the difficulties of determining earnings and profits of foreign companies and even though an exact determination may at times seem near impossible, American tax accountants and revenue agents invariably have been able to work with the concept in determining the foreign tax credit.

However, as I stated before, I seriously question whether the use of earnings and profits of a foreign company should be extended to the extent of becoming a base for a direct annual tax on U. S. shareholders and particularly individual shareholders. The use of earnings and profits of a nontaxable entity as a tax base conceivably could deny the taxpayer the benefit of the various tax reduction alternatives and elections that are otherwise available to a U. S. taxpayer as, for example, the net operating loss deduction; the LIFO inventory method or the declining balance depreciation method.

And, secondly, while the difficulties of an earnings and profits determination may be tolerable in a factor that is used to compute the foreign tax credit of a *corporation*, they may well be intolerable in a base for a broader and direct tax on *individuals*. Or, stated another way, it is one thing to require a corporate taxpayer having expert accounting personnel to obtain, assemble and submit information of this complexity in support of a credit claimed against U. S. tax on income it has received from abroad; it is quite another to impose this same burden on a 10 per cent individual stockholder in support of the taxability of income that he *hasn't* received from abroad. The resultant compliance and reporting requirements, to say the least, would be among the most relatively difficult imposed by our tax law and in my opinion would result in a bogdown.

The enforcement problems would be equally grave. It is highly unlikely that the Treasury could verify directly the accuracy of the base for reporting the proposed tax on earnings and profits of foreign subsidiaries. In addition to the problem of staffing to conduct examinations of records maintained in various foreign languages, in some jurisdictions Treasury agents may even be denied direct access to records of local companies. Indeed, I am informed that examination of the records of a Swiss corporation by agents of a foreign state without the permission of the Swiss Government is forbidden by statute. Whether the Swiss Government would cooperate in permitting direct examinations, I don't know. But these are the sorts of questions unnatural and strained legislative concepts give rise to—and invariably an attempt by one taxing jurisdiction to encroach upon the domain of another, however indirectly, most certainly will provoke problems of resistance or retaliation.

Conclusion

In conclusion, Gentlemen, I submit that the compliance and administrative problems that are inherent in this proposal to tax U. S. shareholders on the earnings and profits of foreign corporations render the proposal relatively impractical, ineffective and impotent. I cannot conceive of our government relying for significant revenues upon prerogatives and information that are solely within the control of a foreign government or its subjects. This would be an ignominious position for us to be in, let alone an undependable and elusive base for U. S. income taxation.

Hartford, Connecticut

By John R. Berthoud

Prior to 1958, all of the Firm's clientele in Connecticut were served by our New York and Boston offices. As the number of our clients in this state was steadily increasing, the desirability and need for an office in Hartford became more and more apparent. In March, 1958, the Firm opened its twenty-first domestic office at 37 Lewis Street in downtown Hartford. Because of the concentration of stock and insurance brokers, CPAs, lawyers and other professional people, Lewis Street is known affectionately as the "Little Wall Street" of Hartford.

A number of experienced accountants from the New York office were selected as the nucleus of the staff of the new office. It took very little time for us to move to Connecticut and become comfortably settled in the Greater Hartford area. We have added to our staff locally and have recruited graduates of the Universities of Hartford, Connecticut, and Vermont. Our clients include insurance companies, public utilities, a wide range of industrial concerns, non-profit organizations, and numerous businesses and individuals.

So much for our office and its operations. The principal purpose of this article is to describe some of the attributes of Central Connecticut as a place in which to live and work. To begin with, geographically, or topographically, Connecticut is truly remarkable. Its 5,000 square miles of gentle hills, lakes, and river valleys are still over two-thirds woodlands. Although dairy, fruit, and vegetable farming in the surrounding area is extensive, the farming industry has been surrendering slowly to the mass production techniques of the great agricultural states and each year more farm acreage is abandoned, often to revert to its natural state. Evidence of this may be seen throughout the state in the form of old stone walls, built perhaps 200 years ago, running through woodlands and meadows. The landscape is difficult to describe; it is always being "discovered" by people who come to Connecticut for the first time. One need only drive along any highway or road virtually anywhere in the state to find mile after mile of serenity and beauty. White clapboard churches and colonial homes attest to the ancestry of almost every city and town. With rare exceptions winters are not severe and summers are balmy. The weather in the Spring and Fall is always fresh and vigorous.

Hartford and Greater Hartford (encompassing the surrounding towns within an approximate ten-mile radius) are geographically

in the center of the state, 100 miles equidistant from Boston and New York City. The insurance industry in the city is well-deservedly world famous and, among the thirty-two insurance companies whose home offices are in Greater Hartford, there are the two largest multiple-line companies in the United States. The insurance industry of Hartford employs about 25,000 people and contributes greatly to the economic stability of the area. Because of this great insurance reputation, many people from outside of Connecticut are not aware of Hartford's other major contribution to Connecticut's distinction of being the most industrialized state in the Union. In Greater Hartford there are about 850 concerns engaged in heavy, medium, and light industry employing over 90,000 people in the manufacture of such diverse products as aircraft jet engines, precision machine tools, brushes, electrical equipment, business machines, helicopters, and nuclear reactors.

Just two more statistics will clearly demonstrate the soundness of the economy in Greater Hartford. First, for all but five of the past thirty years, Hartford has been first in the nation in net income rating per family with the current high figure of $8,076. Secondly, and as a consequence of the above, the retail sales per family of $6,431 places Hartford fourth among the nation's sixty-one largest cities.

Upon this solid and stable base, Greater Hartford is now undergoing a major face lifting which, when completed about five years from now, will make the city and suburbs the showpiece of New England. The largest of these projects involves slum clearance and construction of two skyscraper office buildings, a broadcasting

JOHN R. BERTHOUD *is Resident Partner in the Hartford office. He received his B.S. degree in Economics from the University of Pennsylvania in 1947, and his CPA certificate in New York in 1951; he also holds Certificates in Connecticut and Louisiana. Mr. Berthoud is a member of the Insurance Accounting and Statistical Association, the Institute of Internal Auditors, N.A.A., the Connecticut Society of CPAs and the American Institute. He is active in the Chambers of Commerce of Connecticut and of Greater Hartford. His hobbies include golf and bridge. Mr. Berthoud and his wife and infant son live in West Hartford.*

studio, a hotel, and a shopping center in downtown Hartford. For this project, known as the Constitution Plaza development, the land has been acquired and cleared, the financing completed, the spadework begun, and, as of this writing, the steelwork for the first of the buildings is up. Adjacent to Constitution Plaza, one of the major insurance companies will break ground shortly for its own new home office building. This fourteen-story structure will be elliptically shaped (the first design of its kind in the world), an architectural innovation that has already been widely acclaimed. A total of six other major projects is all past the drawing board stage (some have already been started) and include expressways, circumferential highways, pedestrian shopping malls, a convention-exhibition hall, a 1,000 unit housing project for middle-income families, a civic center, a new federal office building, a combination park, marina and heliport and others. Just two miles from the center of downtown Hartford, a 150-acre industrial park, with full airport and highway facilities, has just been opened. The University of Hartford, the city's own privately endowed university, is growing rapidly on a beautiful campus in the suburbs. Typical of the civic spirit of the area is the award recently given to the Chamber of Commerce for being the best of its size in the country.

In addition to all the advantages enumerated above, there are those of ideal twentieth-century living. I have spoken of the climate and the surrounding countryside. Let me mention some other advantages. Virtually every working man and woman in the area is within fifteen minutes commuting distance from some of the most attractive suburbs in the East. The area abounds with golf and country clubs; it is only a short drive to the Connecticut and Rhode Island shorelines and their innumerable recreation facilities. Most of the remainder of New England and its world famous summer and winter vacation resorts are less than a day's drive from Hartford, and New York City is less than a three hours' drive or a short train ride away. The city has a cultural heritage all its own, with its own symphony orchestra, one of the best art museums in the country, and an auditorium which is host each year to some of the best of the world's theatrical and musical artists. Within a hundred-mile radius of Hartford is a concentration of some of the finest and most famous preparatory schools, colleges, and universities in the world and Greater Hartford itself has an excellent public school system. One final note: The state is financially sound and we do not have a personal income tax.

Recent Library Acquisitions

By Dorothy Kasman (New York Office)

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Speaking Engagements

(The Speaking Engagements listed below cover the quarter January 1 through March 31, 1961.)

Date	*Speaker*	*Organization*	*Topic*
Jan.			
6	John W. Heastings, Pittsburgh	Pennsylvania Institute of CPAs	Case Studies on Tax Practice
9	Alvin H. Carley, Boston	New England Purchasing Agents' Association	Auditing a Purchasing Department
10	Raymond E. Graichen, Philadelphia	AMA Orientation Seminar, New York City	Tax Considerations in Acquisitions
10	Mark E. Richardson, New York	West Side Association of Commerce in the City of New York	The Coming Crisis in New York City Finances
10	Herman Stuetzer, Jr., Boston	Corporate Fiduciaries of Boston	Value of Capital Stock
17	Curtis J. French, Louisville	N.A.A., Louisville Chapter	Panel Discussion—The Annua Audit: Bane or Blessing?
17	Ray H. Oleson, Rockford	N.A.A., Rockford Chapter	Improved Information for Top and Middle Management
18	P. L. Defliese, New York	Robert Morris Associates, New York Chapter	Panel Discussion — Substandard Reports and What to Do About Them
18	H. E. Magnusen, Jr., New York	New York State Society of CPAs, Nassau-Suffolk Chapter	Preliminary SEC Procedures
18	William McHugh, New York	Metropolitan Controllers' Association	The Role of Internal Audit as Viewed by the CPA
18	G. W. Welsch, Dallas	Petroleum Accountants Society of Midland	Tax Savings Ideas
19	Robert L. Burton, New York	Middle Management Group of Combustion Engineering, Inc.	Budgeting and Forecasting
19	Maurice B. T. Davies, Los Angeles	California Society of CPAs, Bakersfield Chapter	Management Services Referrals
19	John W. Heastings, Pittsburgh	Society for Advancement of Management, Central Penn. Chapter	Suggestions for Minimizing Individual Income Taxes
23	Francis A. Gallagher, Rockford	Newcomers Club of Rockford	Personal Income Taxes
24	Madonna E. Newburg, Los Angeles	American Society of Womrn Accountants, Los Angeles Chapter	Panel Discussion—Taxes
26	Herman C. Heiser, New York	N.A.A., Chicago Chapter	Direct Costing
26	L. E. Hoffman, Tulsa	American Institute of Metallurgical Engineers	Expense Accounts: Can Yours Stand Investigation?
26	Joseph E. Tansill, Chicago	Adult Education Class, Sycamore, Illinois	Your Federal Income Tax
Feb.			
1	Richard W. Russell, Los Angeles	UCLA, class in Oil Industry Accounting	Oil Company Financial Statements
6	Richard L. Denney, Hartford	New Haven College	Connecticut Corporation Franchise Tax
7	J. Paul Finnegan, Boston	Boston Tax Council	New Look in Expense Account Reporting
7	Michael Shegda, New York	Systems & Procedures Association, Chicago Chapter	Reducing Costs Through Effective Production Contro

Date	*Speaker*	*Organization*	*Topic*
Feb.			
7	G. W. Welsch, Dallas	Classroom Teachers Association	Tax Tips for Teachers
8	Martin J. Hanlon, San Francisco	California Society of CPAs, San Francisco Chapter	Some Famous Tax Problems of Some Famous and Infamous People
13	Herman C. Heiser, New York	National Office Management Association, Wilmington	Electronic Computer Developments
14	Tibor Fabian, New York	Operations Research Society, Philadelphia Chapter	Computer Simulation of Administrative Procedures
14	J. Paul Finnegan, Boston	Stoughton Lions Club, Stoughton, Mass.	What's New in Federal Income Taxes
14	Jerome Y. Halperin, Detroit	Port Huron Junior College	Taxation for Small Businesses
14	Warren G. Wintrub, New York	American Society of Women Accountants, New York Chapter	Estate Planning
15	Raymond E. Graichen, Philadelphia	N.A.A., Washington, D. C.	Accounting Method Changes
16& 23	Sidney Kess, New York	N. Y. U. School of General Studies	Tax Planning for a Closely Held Corporation
20–22	W. G. Casey, Boston	AMA, New York City	Chairman, Seminar, Revitalizing Cost Accounting System
20	John J. O'Donnell, Detroit	AMA Seminar, New York City	Cost for Inventory Management and Production Planning
21	Richard L. Denney, Hartford	N.A.A., Hartford Chapter	Connecticut Taxation of Corporations
21	Howard L. Swiger, James W. Plate, Rockford	Rockford Chamber of Commerce—Career Nights	Accountant, CPA, Bookkeeper
23	Tibor Fabian, New York	Wharton School of Finance, University of Pennsylvania	Simulation as a Tool for Management Decision-Making
23	Madonna E. Newburg, Los Angeles	Manhattan Beach Community Church, Women's Group	Income Taxes—Women's Viewpoint
24	Joseph W. Bower, Pittsburgh	Alpha Tau Chapter, Beta Alpha Psi Fraternity, University of Pittsburgh	Public Accounting
27	Maurice B. T. Davies, Los Angeles	American Association of School Administrators	Decentralizing Administrative Functions in Large School Districts
27	William H. Lundquist, Philadelphia	AMA Seminar, New York City	Discussion leader—Effective Utilization of Direct Costing
Mar.			
1	William H. Lundquist, Philadelphia	AMA Seminar, New York City	Discussion leader—Effective Utilization of Direct Costing
27	James D. McMenamin, Philadelphia	Standard Engineers Society	Standardization and Cost Reduction
28	J. Paul Finnegan, Boston	Hingham Lions Club, Hull, Mass.	What's New in Federal Income Taxes
28	Herman C. Heiser, New York	American Meat Institute, Palm Springs, California	Profit Planning for Meat Packing Companies
28	Angelo Nastasi, Baltimore	North Baltimore Kiwanis Club	Current Tax Developments
28	Joseph E. Tansill, Chicago	N.A.A., Calumet Chapter	Depreciation

Date	*Speaker*	*Organization*	*Topic*
Mar.			
7	P. L. Defliese, New York	St. John's University Accounting Club	Generally Accepted Accounting Principles
8	R. M. Leng, New York	Wagner College	Careers in Accounting
9	Burton L. Tacke, Philadelphia	Upper Darby High School, Vocational Guidance Clinic, Drexel Hill	Public Accounting as a Profession
13	Joseph J. Hyde, San Francisco	Tax Executives Institute, San Francisco Chapter	Panel discussion—Foreign Taxation
13	Harry J. Spellman, Philadelphia	Lions Club, Haverford	Tax Planning for the Individual and Small Businessman
14	Louis M. Bradley, Los Angeles	The Accounting Society, University of California	Recent Developments in the Public Accounting Profession
15	Michael P. Ferro, San Francisco	American Society of Women Accountants, San Francisco Chapter	Analysis of Financial Statements
15	James E. Meredith, Jr., Philadelphia	Pennsylvania Institute of CPAs, Lehigh Valley Chapter, Allentown	Management Services by CPAs
16	R. G. Ankers, New York	Rider College, Inter-Collegiate Accountants' Club Seminar	Future of Accounting Education
16	Herman C. Heiser, New York	N.A.A., Fort Worth Chapter	Electronic Data Processing
16	Alfred L. Hunt, San Francisco	N.A.A., Peninsula-San Jose Chapter, Palo Alto	Control Side of Budgeting
16	Lewis A. Martorano, New York	Society for Advancement of Management—Central Pennsylvania Chapter, Bellefonte	Sales Forecasting and Budgeting
16	James E. Meredith, Jr., Philadelphia	N.A.A. Seminar, New York City	The Over-all Budget for Coordinated Planning
20	James E. Meredith, Jr., Philadelphia	American Society of Women, Philadelphia Chapter	Management Services by CPAs
21	Alvin H. Carley, Boston	Small Business Clinic, Westfield, Mass.	What to Expect From Your Records
21	T. W. McKibben, Tulsa	Architectural League of Tulsa	Income Tax Problems of the Professional Man
22	Herman C. Heiser, New York	Folding Paper Box Association of America, Chicago	1960 Management Ratios Report
23	P. L. Defliese, New York	Virginia Society of CPAs, Richmond Chapter	Panel member—Committee Activities
23	Robert S. Lappin, Boston	Rotary Club, Brockton	Taxation of Individuals
24	William Ragsdale, Jr., Birmingham	Beta Alpha Psi, University of Alabama	The Duties and Responsibilities of a Public Accounting Staff Member
27	Herbert H. Schueller, New York	NYU Tax Study Group	Panel leader—New Developments in Foreign Operations
28	Raymond E. Graichen, Philadelphia	N.A.A., Philadelphia Chapter	LIFO Dollar Valuation
28	Jerome Y. Halperin, Detroit	Muskegon Community College	Taxation for Smaller Businesses
28	James E. Hammond, San Francisco	Management Development Seminar	Interpretation of Financial Statements
31	Frank P. Smith, New York	A.A.A., Southwestern Meeting, Dallas	The Training Program of the National Accounting Firm

PRIOR SINCLAIR

Prior Sinclair—In Memoriam

It is with deep regret that the Firm reports the death of Prior Sinclair on July 14, 1961. He was 78 years old.

Mr. Sinclair had been a leader in the accounting profession in the United States for several decades, and had served as Managing Partner of this Firm for a number of years. He was a past president of the New York State Society of CPAs and had also been a member of Council and of the Executive Committee of the American Institute of CPAs.

In 1941, Mr. Sinclair received the New York University Medallion Alumni Service Award; in 1948 the Society Service Award of the New York State Society of CPAs; and in 1951 the New York University Dean John T. Madden Memorial Award. In addition to his service to professional societies, he had also written many articles on accounting subjects and was author of *Budgeting*, an authoritative text in its field.

Mr. Sinclair had served in the nation's armed forces in World War I and later served in supervisory and consultant capacities to the U. S. Shipping Board and the U. S. Navy.

Mr. Sinclair was born in Blackburn, England, and was naturalized in this country in 1915. After graduation from NYU, he joined the Firm, and became a partner in 1928.

He was a member of a number of organizations including the Union League Club, the Metropolitan Opera Club, the St. George Society, the English Speaking Union, the Pelham Country Club and the New York University Club.

The Firm's sympathies are extended to his survivors, including his wife, Selina; his son, Robert; and three grandchildren; also his sister, Mrs. L. Watson.

Notes

BIRMINGHAM

Mr. William Ragsdale, Jr. has been elected honorary member of the University of Alabama Chapter of Beta Alpha Psi, the national accounting fraternity.

BOSTON

The Boston office sponsored a Junior Achievement Company, "Financo," which has completed a most successful year. "Financo" received several achievement awards and its president was chosen president of the year for Eastern Massachusetts Junior Achievement. The volunteer advisors for the past year were Messrs. Bernard F. O'Neil, Jr., Arthur C. Barket, Stephen R. Howe, Donald R. Jones, Sr., Robert S. McKenna, Laurence S. Mitchell and Maurice J. Whalen.

Mr. William E. Doten has been elected Chairman of the Board of Selectmen of North Reading, Massachusetts.

Mr. J. Paul Finnegan has been re-elected to a one-year term as Secretary to the Advisory Board of the Town of Scituate. He has also been elected a member of the Boston Life Insurance and Trust Council.

Mr. Edward W. Higbee is a member of the Accounting Practices and Office Procedure Committee in the Town of Hingham.

Mr. Albert E. Hunter has been re-elected to the office of Treasurer of the Greater Boston Chamber of Commerce.

Mr. Francis E. Moore has been re-elected Treasurer and Board Member of the Boston Young Men's Christian Union.

Mr. Herman Stuetzer, Jr. will serve in the coming year as a member of the Tax Committee of the United States Chamber of Commerce. He has been elected Secretary of the Boston Estate & Business Planning Council for a year, and for a three-year term as a member of the Executive Committee of the Executives Club of the Greater Boston Chamber of Commerce. The fourth edition of "Massachusetts Taxation of Corporations" by Mr. Stuetzer was published in February. Recently, Mr. Steutzer was named by the Governor of Massachusetts to be one of five managers to operate the South Shore Transit Authority which was recently formed by statute passed by the Massachusetts Legislature. This is to take over the Old Colony Division of the New Haven Railroad and set up and operate a rapid transit service from the South Shore to Boston.

Mr. Stanley W. White, one of our well-known managers, has retired after thirty-seven years of service in the Boston office. A luncheon in his honor was tended him by his many friends and associates. Even though retired, Mr. White will continue to be quite active professionally, as he has accepted an executive post in industry.

Mr. William R. Wilson has been elected to the Board of Public Welfare in Wrentham for the coming year.

Mr. John A. O'Callaghan has received his CPA certificate.

CHICAGO

The University of Illinois Alumni Association presented Mr. John W. Conrad with a Loyalty Award in grateful appreciation of continuing devotion and service to the University of Illinois.

Mr. Albert H. Degener is currently serving as the Editor of the *Chicago Reporter*, the monthly newsletter of the Chicago Chapter of NAA.

Mr. William R. Hindman acted as Associate Chairman of the Orientation Seminar of the American Management Association in Chicago in May.

Mr. George H. Kern has been elected President of the CPA Toastmasters' Club for the year 1961–62.

CINCINNATI

Mr. Robert W. Davis is serving the University of Michigan's Cincinnati Club as Treasurer.

Mr. Raymond J. Leisner has been elected President of the Cincinnati Chapter of the Systems & Procedures Association.

DALLAS

Mr. G. W. Welsch's article, "Tax Accounting for Oil Income and Deductions During Periods of Litigation and Dispute," which appeared in Volume 42 Number 1 of the Lybrand Journal, will appear in the *Journal of Taxation* shortly. Mr. Welsch has been elected Treasurer of Golf Executives, Ltd., which sponsors the Dallas Women's Golf Tournament for charity each fall.

DETROIT

Mr. Frank L. Gofrank has been elected President of the Lost Lake Woods Club for the year.

Mr. John O'Dell has been appointed to the Businessmen's Advisory Committee for Eastern Michigan University.

Mr. Samuel Webster received the Wall Street Journal award at an Honors Banquet for graduating students following a meeting of the Businessmen's Advisory Committee at Eastern Michigan University.

LOS ANGELES

Mr. Louis M. Bradley has been initiated as an honorary member of Beta Alpha Psi, Iota Chapter at the University of Southern California.

Albert G. Moss

We regret to report the death, on March 11, 1961, of Albert G. Moss after a short illness. He was 75 years of age.

Mr. Moss was born in Memphis, Tennessee, on March 17, 1886. He entered public accounting in 1910 as a member of the staff of a firm in Memphis, Tennessee, after having been engaged in the fields of banking and manufacturing. He entered the employ of the Dallas firm of W. P. Peter & Company in 1911 and, in 1913, was admitted to partnership, the firm name being changed to Peter & Moss; this firm was merged into Lybrand, Ross Bros. & Montgomery in 1930.

During World War I he was stationed in Washington, D. C. and served as Chief of Commandeering Section of the General Staff.

The "Major," as he was affectionately known, was active in civic affairs, serving the Town of Highland Park (near Dallas) in many capacities including that of mayor.

Mr. Moss was a member of the American Institute of CPAs and the Texas Society of CPAs. He was a charter member of Brook Hollow Golf Club, and a member of the Dallas Athletic Club, the City Club and the Koon Kreek Klub. He is survived by his wife; a daughter, Mrs. Robert Olmsted, of Dallas; two grandchildren and one great-grandchild.

Mr. Frank Y. Garrison has been appointed by the Los Angeles Chapter of the California Society of CPAs to represent the Society on the Joint Accounting Career Council of Southern California.

As Treasurer of the Los Angeles Junior Chamber of Commerce, Mr. James M. Nicolai presented the City Flag to the Los Angeles Angels Baseball Club on opening day.

Miss Madonna E. Newburg will serve as a member of the Board of Directors of the American Society of Women Accountants, Los Angeles Chapter, for the coming year.

Mr. J. Walker Voris is serving as Chairman of the Nominating Committee of the Los Angeles Chapter of the Systems and Procedures Association.

Mr. Theodore C. Vournas will be serving as Chairman of the Board of the Mr. and Mrs. Club of Los Angeles, Inc., which is a social group of St. Sophia Cathedral. He is also working as a member of the Fund Raising Committee Summer Camp Fund of St. Sophia Cathedral.

The following members have received their CPA Certificates from the State of California:

Kenneth V. Domingues — John F. Lillicrop
Pat Rossi, Jr.

LOUISVILLE

Mr. Thomas K. Baer served as a panel member at a meeting of guidance counselors of high schools throughout the State during the Kentucky Education Association meeting in Louisville, sponsored by the Public Relations Committee of the Kentucky Society of CPAs.

Messrs. Raymond Broderick and Norris Krall have been accepted into membership in the Kentucky Society of CPAs and the American Institute of CPAs.

Mr. Harold W. Glore has been commissioned a Kentucky Colonel by the Governor of Kentucky.

Mr. J. Thomas Moore has been elected Vice President of the Miami University Alumni Association.

NEW YORK

Mr. Raymond G. Ankers continues to serve as a member of Council of the American Institute, and he is Chairman of the Activities Committee which is made up of the elected members of Council from New York State. Recently, Mr. Ankers was

elected Chairman of the Council on Accountancy, an advisory group appointed by the Board of Regents of the State of New York.

Mr. Edward G. Carson was a Sponsor of the Dinner of The National Conference of Christians and Jews which honored Mr. Charles R. Cox, President of Kennecott Copper Corporation, for his distinguished service. Mr. Carson was Chairman of the Annual Dinner Committee of the N.Y.U. School of Commerce Alumni Association, and will be Chairman of the Alumni Fund for this group during the coming year. Recently Mr. Carson accepted an invitation to act as a member of the Board of Directors of the New York University Club.

Mr. Reed L. Colegrove is acting as Chairman of the Accountants' Division, New York City Cancer Committee of the American Cancer Society, Inc. for the 1961 Cancer Appeal.

Mr. H. B. Fernald was presented with a citation at the N.Y.U. Men in Finance Club meeting in April. Mr. Fernald was a founder of the club.

Mr. Joseph A. Giuffre is President of the Fourth Ward, Third and Sixth Districts, Democratic Club of Perth Amboy, New Jersey. He has been appointed by the mayor to serve on The Perth Amboy Human Relations Commission.

Mr. A. R. Jennings received an honorary degree of Doctor of Commercial Science from Pace College at their commencement exercises. He has been elected a Trustee of the Committee for Economic Development.

Mr. Charles R. Jones was awarded an Honorable Mention in an essay contest sponsored by the Detroit Chapter of the Institute of Internal Auditors. "Internal Auditing—When and Why" was the subject of his paper.

Mr. Mark E. Richardson is serving as Chairman of the Committee on Taxation of the New York Chamber of Commerce. W. Averell Harriman requested Mr. Richardson to be a member of the Honorary Committee for the Ambassadors' Dinner of the United States World Trade Fair which was held in May. Mr. Richardson is Chairman of the Accountants Division, Downtown, of The Greater New York Fund.

Mr. Joseph W. Hall, Assignment Manager, passed the November Certified Public Accountant Examination in the State of New York.

The following members of the staff passed the November 1960 Certified Public Accountant Examination in the State of New York:

Martin Abrahams — William M. Cadden
Alvin L. Begleiter — James E. Laheney
Joseph J. McFadden

Three women in our New York office recently retired. To each of them go our wishes for a long and happy retirement.

Miss Lillian M. Arnold retired at the end of March after 36 years of service with the Firm. During most of these years she acted as the partners' secretary and her ability and loyalty above and beyond the call of duty are known to all. Miss Arnold was honored at a luncheon given by the partners, and by gifts from partners and fellow employees.

After more than 50 years of service, Miss Louise T. Ramsteck retired at the end of June. At luncheons given in her honor by the former Loomis, Suffern & Fernald partners and her many Lybrand friends, Miss Ramsteck was shown appreciation for her long and faithful devotion as a secretary to Mr. Henry B. Fernald.

Miss Rose Sheerin retired in April as secretary to partners. As tokens of appreciation for her 44 years of service, Miss Sheerin received several gifts and was the guest of honor at luncheons given by the former Loomis, Suffern & Fernald partners and by her many friends at Lybrand.

PHILADELPHIA

Mr. Roger F. Burd is working as Chairman of the Finance Committee for St. Paul's Evangelical Lutheran Church in Glenside, and is a member of the Board of Trustees for the Mary J. Drexel Home and Philadelphia Motherhouse of Deaconesses in Gladwyne.

Mr. Edward F. Habermehl wrote an article, "Recent Pennsylvania Tax Legislation," which appeared in the April issue of *Spokesman*.

Samuel F. Mirandy

We announce with regret the death of Samuel F. Mirandy, a partner in the New York office, on April 6, 1961. Mr. Mirandy joined Lybrand, Ross Bros. & Montgomery on his graduation from Columbia University in 1934. Surviving are his widow, Nancy; a son, Louis; a daughter, Joan; his mother, Mrs. Margaret Mirandy; two brothers and three sisters.

Mr. James E. Meredith, Jr. is presently serving as a team leader for the Franklin Institute Development Fund.

Mr. John L. Moneta has been re-elected Treasurer of the Philadelphia Country Club for the second consecutive year.

Mr. Edward P. Mullen will be Assistant Treasurer of the Aronomink Golf Club for the coming year, as well as Chairman of the Accountants' Division for the Catholic Charities Appeal, Archibishop's Committee of the Laity.

Mr. Philip J. Taylor is Chairman of the Finance Committee of The Salvation Army of Pennsylvania.

Mr. James H. Weber has been elected Financial Secretary of Christ Evangelical United Brethren Church of Lansdale.

Mr. Raymond L. Woodall, Jr. is a member of the Auditing Committee of the Philadelphia Chapter of National Machine Accountants Association.

Mr. Harry C. Zug has been elected to the Board of Directors of the Pocono Lake Preserve for a three-year term.

PITTSBURGH

Mr. Kenneth P. Johnson has been appointed to membership on the Program Committee of the Pittsburgh Chapter of the Institute of Internal Auditors.

ROCKFORD

Mr. Robert W. Myers has been elected Treasurer of the Rockford Rotary Club.

Mr. Edward J. Rudnicki has been elected Treasurer of the Forest City Toastmasters. Ray H. Oleson is also a member of this group.

ST. LOUIS

Mr. Carlin P. Oliphant has been elected President of the St. Louis Chapter of Systems and Procedures Association.

Mr. Thomas J. Snowden was elected President of City House, Barat Hall Association.

SAN FRANCISCO

Mr. David A. Biasotti is Vice Chairman of the Peninsula Area for the University of Santa Clara Alumni Fund Drive.

With David H. Brodie as Chairman of the 1961 Membership Campaign of the Central Branch of the Y.M.C.A., the group more than met their goal this year.

Mr. Claude R. Giles was reappointed as Consulting Professor of Public Accounting for the Graduate School of Business at Stanford University.

Mr. James E. Hammond is a member of the A.I.C.P.A.'s Project Advisory Committee on Accounting for Nonprofit Organizations. He will also serve as Director of the Peninsula Golf and Country Club for a three-year term.

Mr. J. Wesley Huss is working on the 1961 United Crusade of the United Bay Area as Chairman of the CPA Group. He will also serve as a member of the Membership Committee this year for the San Francisco Chamber of Commerce.

Mr. C. John McDowell has accepted an invitation to serve on the National Panel of Arbitrators.

Mr. Calvin H. Nelson has been elected to membership in the Rotary Club and will serve on the Reception and Hospitality Committee.

Mr. L. Robert Van Geffen is Chairman of the Membership Committee of the San Francisco Estate Planning Council. He has been elected to a two-year term as Director of this Council.

The following members of the staff have received their CPA Certificates:

Gene A. Burghardt
Walter A. Cox
Arthur Ostrander